COMMONWEALTH OF AUSTRALIA

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HOUSE OF REPRESENTATIVES

STANDING COMMITTEE ON ECONOMICS, FINANCE AND PUBLIC ADMINISTRATION

Reference:International financial market effects on government policy

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HOUSE OF REPRESENTATIVES
STANDING COMMITTEE ON ECONOMICS, FINANCE AND PUBLIC ADMINISTRATION

Wednesday, 9 February 2000

Members: Mr Hawker *(Chair)*, Mr Albanese, Ms Burke, Ms Gambaro, Mrs Hull, Mr Latham, Mr Pyne, Mr Somlyay, Dr Southcott and Mr Wilton

Members in attendance: Mr Albanese, Ms Burke, Ms Gambaro, Mr Hawker, Mr Pyne, Mr Somlyay, Dr Southcott and Mr Wilton

Terms of reference for the inquiry:

Matters referred for inquiry into and report on:

1. The implications of the globalisation of international financial markets for the conduct of fiscal and monetary policies in Australia, including medium-term and other strategies to cope with potential volatility in markets.

2. Information requirements for the stable and efficient operation of international financial markets, including the provision of information by governments and disclosure by market participants, especially by large market participants including highly leveraged institutions.

3. The relevance to these issues of recent developments in the international framework for financial regulation.

WITNESSES

Committee met at 9.05 a.m.

BATTELLINO, Mr Ric, Assistant Governor (Financial Markets), Reserve Bank of Australia

GRENVILLE, Dr Stephen Alexander, Deputy Governor, Reserve Bank of Australia

MACFARLANE, Mr Ian John, Governor, Reserve Bank of Australia

CHAIR—I declare open this hearing of the House of Representatives Standing Committee on Economics, Finance and Public Administration inquiry into international financial markets. This is the first public hearing for the inquiry which is examining the effects of globalisation of international financial markets on Australia's monetary and fiscal policies and the strategies needed to deal with market volatility. A major aspect of this is to examine the role of hedge funds in the Asian financial crisis and especially their role in the attack on the Australian dollar in 1998 and, more recently, some of the impact we have seen on the Australian dollar in the last week.

Another important aspect of the inquiry is an examination of information requirements for the stable and efficient operation of international financial markets and the relevance of recent developments in the international financial architecture to Australia's situation. The witnesses we will hear today represent some of Australia's main participants in international financial markets. They are the Reserve Bank, the Australian Stock Exchange, the Sydney Futures Exchange and Dr Carolyn Currie of the Sydney University of Technology. The committee is keen to get on with the hearing so I will move to the procedures and call for the witnesses.

I welcome here today the representatives of the Reserve Bank and I remind you that the evidence that you give at the public hearing today is considered to be part of the proceedings of parliament. Accordingly, I advise you that any attempt to mislead the committee is a very serious matter and could amount to a contempt in the parliament. The committee has received your submission No. 7 and it has been authorised for publication. Are there any corrections or amendments you would like to make to your submission?

Mr Macfarlane—No.

CHAIR—Do you wish to make a brief opening statement before the committee proceeds to questions?

Mr Macfarlane—I do not have an opening statement prepared but I would like to record that I think the terms of reference of the committee are very interesting and very sensible and I am sure that we will be able to have a very fruitful discussion on the subject.

CHAIR—Thank you, Mr Macfarlane. One of the areas where no doubt there is considerable interest is the question of when you actually go to setting interest rates. What is the level of recognition you give to what the other central banks around the world are doing and how much does this influence you when you make those decisions?

Mr Macfarlane—I think it is a relatively secondary matter. The monetary policy is determined essentially by the needs of the domestic Australian economy and that is the case most of the time. There are occasions where international developments can become very important, particularly in times of financial crisis, but that is unusual. Most of the time monetary policy is made essentially in terms of the needs of the Australian economy and that was certainly the case on this occasion.

That does not mean that the international environment is not important. The international environment can be very important because it can be a major determinant of how we see growth and inflation developing in Australia, so we have to act in an international environment. But in no sense is there a process whereby we are either coordinating it with other central banks or sitting on the edge of our seat waiting to see whether someone has moved so we might move. That is not the process. The process is that we look at the needs of the Australian economy and we act in light of that.

It is also true, particularly at the moment, that the international business cycle has been relatively well coordinated – in other words, there are a lot of countries going through the same sort of reassessment at the same time as we have been going through the reassessment – so it is not surprising, in our view, that a lot of countries have come to essentially the same conclusion that we came to, which was it would be unwise to continue with a very expansionary stance of monetary policy that we had through 1999 and to continue that through the changed circumstances of 2000 and 2001. It is clearly true that a lot of countries have moved in a similar way at a roughly similar time but they have done so because they have been experiencing very similar conditions.

CHAIR—Is there any particular reason why most of the other countries, like the United States, New Zealand, Canada, Europe, have all seemed to go 25 basis points and why we went 50?

Mr Macfarlane—It is not true that the others all went 25. I note that the UK, for example, and New Zealand both had a 50 and a 25, just the same as we did. I think the US is different in that the US is very sensitive, particularly to its stock market, and I think the US has to tread perhaps rather more gingerly than some of the other countries.

CHAIR—Can you explain what you mean by the US having this stock market question?

Mr Macfarlane—When we look around and we see which countries have some element of their economy which is vulnerable or, the other way of looking at it, if you look around and see there are signs of asset price booms, which we know are always vulnerable, it does not require a lot of imagination to realise that, of the countries that moved, the one I think where there is the most discussion about whether its stock market is overvalued, where there have been discussions about irrational exuberance, where there have been discussions about bubbles, is the US.

I do not want to make a judgment on it. I do not know whether it is grossly overvalued and vulnerable, but you can make a case, if you wanted to, for the US. I think you would have a lot of trouble making that case certainly for Australia or New Zealand or Canada or probably the UK. So I think the US has this additional complication that other countries do not have or the other countries have to a very much smaller degree. You can observe it every time Chairman Greenspan makes a speech. The stock market either goes up or goes down on that speech. Every time there is speculation about an interest rate going up by X amount, the stock market changes. If that speculation changes, the stock market changes again. There is a sort of cat and mouse game going on in the US between monetary policy and the stock market to a much greater degree than there is in any other country.

CHAIR—What are the implications of that for Australia? You are saying that he may be influenced in his decision making – may be – by his concerns about the impact on the stock market, but there are other economic factors to consider just as much as the stock market?

Mr Macfarlane—Yes.

CHAIR—What is the likely flow-on to Australia?

Mr Macfarlane—There are a couple of questions there, I think. The first is, you are right that there is more than the stock market in the US. If you look at the underlying US economy and look at the underlying US expansion, it has a lot of similarities with ours, or perhaps we should be more modest and say we have a lot of similarities with theirs. We have both had expansions that have gone on for more than eight years. I think theirs is one quarter longer than ours. We have both had strong growth during those expansions. Our growth has actually been a bit stronger than theirs. I think ours has averaged 4.1 or something, to their 3.7. So there is great similarity in the underlying economies, and we have both enjoyed relatively low inflation. They have both been very successful expansions.

But what I am trying to say is what are the different features about the US? What makes the US different? Whilst there are a lot of similarities, I think one difference is the state of US asset markets, particularly the US stock market. That is the answer to the first question.

The second question is, what are the implications for Australia of the fact that the US is different? Well, I think there are some people who think that if monetary policy is not handled with great subtlety in the United States there could be a big reaction in the stock market. We could have a big fall in the stock market. Some people have been very pessimistic about this and maybe there are reasons to be pessimistic. I am not quite so pessimistic. I think it is possible the US stock market could fall a fair way. It fell a fair way in 1987. That did not in the end have harmful macro-economic effects. It fell a long way in 1929. That did have very harmful economic effects but I think, looking back over those two episodes, we can see that with sensible monetary policy a big correction in the stock market need not necessarily have very serious macro-economic effects. So I am not in the pessimistic school there. I do not myself think that a major correction in the US stock market would necessarily lead to serious macro-economic effects, although I certainly do not rule out that a major correction will occur.

Mr WILTON—Governor, you have just indicated that the two recent interest rate rises were by and large not driven solely by international factors. Can you categorically rule out the GST as having played a part in those decisions?

Mr Macfarlane—Yes. I have no trouble in ruling that out at all and I have ruled it out on a number of occasions and I have ruled it out before this committee three months ago. We would have put up interest rates by three-quarters of a per cent whether there was a GST impending or whether there was not a GST impending.

Mr WILTON—So, to that end, then, can you rule out the GST as a factor in the greater overall magnitude of monetary tightening?

Mr Macfarlane—When we look ahead we cannot rule anything out. I think I said to this committee last time that if the process of the Australian economy adjusting to the GST turns out to be done in an unsatisfactory way, then it will have an implication for monetary policy, but we are not assuming that at the moment. We are working on the assumption that sellers will put their price up by the GST, that wage bargaining will not expect an additional increase in wages to cover for the GST because they have already been compensated once by the fall in income taxes. That is the assumption on which we are basing monetary policy.

I sincerely hope that turns out to be the correct assumption. If it turns out to be the correct assumption, I think we can look forward to a much longer, sustained economic expansion. If it turns out to be the incorrect assumption, things will be a little more difficult. I still do not think that we are going to have such difficulties that it will threaten the expansion, but it is conceivable. Certainly at the moment I can say unequivocally that we have put interest rates up for the same reason those other countries put interest rates up.

We no longer need the expansionary stance that we had in 1999. When we looked ahead a couple of years, as we often do in making monetary policy decisions, and said, ‘What will we think in a couple of years when we look back and what is the sort of standard mistake you could make at this stage of the cycle?’ we always thought that the standard mistake was to keep an expansionary setting on for too long. That is the main reason why we wanted to move away from it.

Mr PYNE—Mr Macfarlane, the Australian government is very committed to making Australia a financial centre for international money markets and has been spending some political capital in this project. When you raised interest rates by 50 basis points, there was some speculation in the financial press that, in fact, this would make Australia a less attractive financial centre in the future. Do you agree with that assessment and, if so, why; if not, why again?

Mr Macfarlane—I certainly do not agree with that assessment and, in fact, I have to express some surprise that I had not heard that one expressed before.

Mr PYNE—Before last week or before this morning?

Mr Macfarlane—It seems to me that the thing that we can do directly to make Australia an attractive place for people to do business in is to have a good economic performance and the main test of that would be further long, sustainable economic expansion. The rise in interest rates, we believe, will contribute to that and that is the major thing we can do. Personally, I cannot see a mechanism whereby raising interest rates in a responsible manner, as has been done here and has been done in a number of other countries – major financial centres like the US and the UK – could in any way be construed as being detrimental to their growth as financial centres.

Mr PYNE—Would you agree that, as Australia's interest rate rises have been commensurate with rises in other financial centres, basically it is not an issue that investors and others would take into consideration?

Mr Macfarlane—It certainly is not an issue. In fact, I think if we had have tried to defy gravity, it might have been harmful. But by doing the sensible thing, I do not think it has done any harm at all.

Mr PYNE—Thank you.

Ms BURKE—I am assuming you are agreeing then with the comments made yesterday the Secretary of the Treasury, Ted Evans, that the rate rise was to create a slowdown in the economy?

Mr Macfarlane—It is true that at the margin higher interest rates would be consistent with slightly lower growth and slightly lower inflation than if you had attempted to maintain a very low and expansionary monetary policy setting through the remainder of the expansion. So, yes, at the margin that has to be arithmetically correct. But that does not mean that you can then simplify to say that the motive for the interest rate rise was that we needed to slow the economy. The motive for the interest rate rise was that we wanted to avoid being excessively expansionary.

Ms BURKE—Do you think it will, therefore, have an impact on households? You have made the comment before that they do have heavy debt at the moment and that the rate rise may have an impact obviously on home borrowers and credit cards. Will it have an impact on mum and dad at home?

CHAIR—Can I interrupt there. Obviously people want to ask questions on the interest rate. We will have a couple more, but I would then like to get to other things.

Ms BURKE—That is my last question.

Mr Macfarlane—The answer is, yes, it does have to. Obviously with anyone who has substantial borrowings – and, as we know, the household sector has borrowed very heavily really over the last couple of years – there will be effects. It is interesting that this is one of the few occasions I can think of when a tightening of monetary policy has actually had a direct effect on the bit of the economy that you could argue was overstretched a bit. Sometimes when you tighten monetary policy people say, ‘You shouldn't have done that. Look what you'll do to the exchange rate. You shouldn't tighten monetary policy. Look what you'll do to investment.’ On this occasion the tightening of monetary policy – that is, the raising of interest rates – will directly affect the bit of the economy which actually was galloping ahead a bit – which was debt-financed consumption – and we cannot deny that it will have an effect on that.

Ms GAMBARO—Governor, regarding the strengths and weaknesses that Australia exhibited during the Asian financial crisis, can you give us a rundown on the market conditions now that would provide some strengths for Australia and protect it from such –

Mr Macfarlane—That is a good question and my interpretation of it is you are actually straying into the main body of the subject matter.

Ms GAMBARO—Yes, I know. I had to get away from interest rates.

CHAIR—I can assure you the committee is coming that way.

Ms GAMBARO—Would you prefer that I asked you about hedge funds?

Mr Macfarlane—No. My interpretation of the question is, `Why did the Australian economy prove so resilient to the Asian crisis given that, in an arithmetic sense, we were more exposed than just about anyone else? Is there something about our financial markets that made us resilient?' I think there are a number of things and I am happy to expound on, if that is really specifically what you want to ask about. It goes to the heart of the subject matter of this hearing.

CHAIR—Mr Somlyay is champing at the bit to ask one more question on interest rates and then we will come back to this question. Is that all right?

Mr Macfarlane—Right, yes.

Mr SOMLYAY—Mr Macfarlane, do any central banks that you know of have a mechanism to take into account the different economic circumstances across their countries and that results of tightening monetary policy may affect the regions differently?

Mr Macfarlane—It is certainly true that in every country there are regional differences and in every country it is true that monetary policy has to operate on the average of the whole country. We certainly are aware of what happens – and I am sure other central banks are – in different regions, but you can only have one monetary policy and that monetary policy has to apply to the country evenly. We are getting into a sensitive subject here, which I am happy to talk about, as with all sensitive subjects. It is conceptually impossible to have separate monetary policies for different regions and, in fact, we have seen a most unusual development in the last decade in that we have seen 11 regions which were called countries, which had 11 separate monetary policies, all join together to form the European Monetary Union. They have actually given up their independent monetary policies for each of their regions and been happy – I am not sure how happy they are, but certainly thought it was in their long-term interest to settle on one monetary policy.

It is as though we were back as six colonies with six different monetary policies and we federated and got rid of six central banks, replaced them with one central bank and one monetary policy. At the conceptual level there is really, and always will be for a country, one monetary policy. The issue you have raised, I think very politely and subtly, is this one which your usually thoughtful and reflective chairman raised slightly less temperately and that is the claim that monetary policy for Australia, in its extreme form, is determined by Sydney. That is clearly absolutely wrong. I do not have any trouble in dismissing that.

If you look at the statistics across the country you can see that is wrong. For example, let us take the biggest component of demand, which is consumption, retail trade. Over the last 12 months retail trade has grown nationally by 7.7 per cent, which is a very strong figure. We were talking about it a minute ago. In New South Wales it grew by 7.6 per cent, in Victoria by 11.1 per cent, in Queensland by 7.4 per cent, in both the territories by over eight per cent. Obviously there were some states which were lower than average. As I said, New South Wales was slightly lower than average there – was about average – but Victoria was the strong one there.

I think I went through these indicators when the committee met last time. Another indicator of asset prices is house prices. Nationally, house prices have gone up by 10 per cent over the last year. Again, Melbourne – not Victoria – leads the field, 20.7 per cent increase. In fact, even if we went over the last three years, Melbourne has had much more in the way of home price rises than Sydney. Even South Australia is above the national average with 13.3 per cent. We could go and look at employment; the same thing. If you look at employment, nationally it has grown by 2.7 per cent. New South Wales has grown a little faster – it has grown at 2.9 per cent – and Victoria has grown at 2.6 per cent, Queensland at two per cent, South Australia at 2.9 per cent, Western Australia at 3.4 per cent.

I only quote these numbers to say that, yes, there are regional differences, but they are not as simple as people think. It is not as though it is only Sydney or it is not as though it is only New South Wales. Another variation on it is to say, 'It's only New South Wales and Victoria' – that is about 60 per cent of Australia anyhow. There are other places that are doing well; in some places they are doing badly. But I do not think there is anything we can do about the fact that you can only have one monetary policy for a country.

CHAIR—This is definitely the last question on it.

Dr SOUTHCOTT—Okay. Governor, when we look at the recession of the early 1990s, there was definitely a regional difference, with South Australia and Tasmania going backwards quite severely. New South Wales and Victoria were fairly flat and Queensland and Western Australia, I believe in terms of state product, did not go into recession. Given the sensitivities involved in the perception of regional impacts of interest rates, would it be possible perhaps in the semi-annual statement on monetary policy to include something like the figures you have just mentioned, showing what gross state product is in each state, final demand, housing and so on?

Mr Macfarlane—Yes, we can. You are right, we could have a more extensive coverage of regional differences. My only comment on your introduction is that my memory of the early nineties recession was that Victoria had an extremely serious recession. It was not just South Australia and Tasmania; it was Victoria as well. In fact, if we take Victoria out of the national figures, it looks like a very mild recession for the rest of Australia.

Ms GAMBARO—I would like to ask you about hedge funds. What threat do hedge funds pose to market integrity and what role did they play in the Asian financial crisis?

Mr Macfarlane—I would like to go back to your earlier formulation, if I can.

Ms GAMBARO—It is up to you.

Mr Macfarlane—I thought your earlier formulation was a good one because it was rather similar to one of the things that was said in the media release that was put out where Mr Hawker said:

It is imperative that Australia develops risk management strategies to reduce the potential of market disruption.

I think that is quite a good way of thinking about it – does the country have a risk management strategy to avoid having the sort of things happen to us that happened to a number of these Asian countries? In fact, we have a risk management strategy – we probably did not call it that – which is responsible for the reason that we did not get into trouble. The major component of that risk management strategy is a floating exchange rate. When we look at what happened in Asia, the countries that had the most severe difficulties had a fixed exchange rate or semi-fixed exchange rate. The countries that did best had floating exchange rates, Australia being the best example. I think the reason Singapore did better than Hong Kong was that Singapore let their currency move and Hong Kong could not; Taiwan did quite well.

The danger with the fixed exchange rate is that it is brittle. It is either working perfectly or it collapses. The other danger with a fixed exchange rate, typically for a country that wants to grow quickly, is that because the country is growing quickly and it has probably got a reasonable amount of inflationary pressures – not a huge amount – it would need to run higher domestic interest rates for its own domestic purposes than, say, the United States would run. You build up a situation where domestic borrowers are very keen to borrow offshore in US dollars or yen or some other currency where they can get very low interest rates. You then end up with a mentality in the country where people are not accustomed to understanding foreign exchange risk and because they are not accustomed to doing that they fall into the trap of taking on these very big unhedged foreign currency exposures. Then, when the currency does collapse – say it falls by 20 per cent – all these borrowers suddenly discover their repayments have gone up by 20 per cent and that is enough to cause insolvencies.

The centrepiece of any risk strategy, I think, if you can do it – and some countries cannot do it – is to have a floating exchange rate where people are accustomed to exchange rates going up and down and where borrowers, particularly corporations and banks, understand foreign currency risk. In most developed countries, the banks cannot take on very much foreign currency risk because they are supervised and, of course, it would be recklessly dangerous for a bank to have a huge amount of foreign currency risk. But even in Australia I think the big corporations understand foreign currency risk very well, too. Our judgment is that they, by and large, do not borrow offshore in foreign currencies unless they have a natural hedge.

For example, if you have a mining company whose receipts are going to come in – in US dollars – it would be perfectly sensible for them to borrow offshore in US dollars because they have a natural hedge. But we do not have the widespread vulnerability built into our system that a lot of those fixed exchange rates countries had where so many of their businesses had borrowed offshore in foreign currency that when their exchange rate collapsed those businesses went broke, not because the things they were producing they couldn't sell, but because they suddenly had an overwhelming debt burden. I wanted to take this opportunity of introducing this by saying that the biggest safety valve or risk management strategy you can have is to have a floating exchange rate.

Ms GAMBARO—So that was a large strength we had and will continue to have.

Mr Macfarlane—I want to expand on that a little bit, too. How can you have a floating exchange rate that works well? A lot of countries have tried it and failed, particularly in Latin America. They tried it and failed. In order to get the system to work well you have to have deep financial markets. The first thing you must have is a government which can borrow in its own currency from its own citizens on long terms. So the Australian government can borrow at 10 years or 12 or 13 years. It was not that long ago when we could not borrow at more than three or four years.

Back when the first bond tender was held I think the longest maturity was four years, but now we have people and not just domestic people but foreigners who are comfortable lending to the Australian government for 10 or 12 years, in Australian dollars. So you have an international confidence that builds up. What that means is not only will they lend to the Australian government in Australian dollars but some Australians who want to borrow offshore can borrow in Australian dollars, so they do not take a foreign currency risk.

This sort of depth in the financial market gives businesses the opportunity to design a package of financing for them that suits them and it doesn't involve them in great foreign currency risk. If the exchange rate goes down by five or 10 per cent it does not cause the huge hardship that it does in most of the fixed exchange rate countries. Or, in some of the countries that have tried to have a floating exchange rate, they realised that when it came under downward pressure, because all these people had borrowed offshore in foreign currency, they were so vulnerable that the governments had to step in and try to resist the fall in the exchange rate. How did they do that? They put up interest rates and so they would get hurt by the rising interest rates rather than by the falling exchange rate. I am sorry that I spent so much time over that.

Ms GAMBARO—No, that is fine. Thank you.

Mr Macfarlane—But I do think that it is the centrepiece of a risk management strategy for a country in a difficult world.

CHAIR—I was just going to follow up that point. In your submission to the committee you said that, with the benefit of hindsight and re-examining the Asian crisis, you felt that the impact of hedge funds was greater than initially anticipated. I think you gave the example particularly of the impact in Thailand. I was wondering if you could just expand a bit more on that and give the committee some thoughts on it.

Mr Macfarlane—All right. Are we going to move on to hedge funds?

CHAIR—Yes.

Ms BURKE—The only thing I was interested in following from that and the comment about the Europeans, is that you do not see then any benefit in having a single Asian currency that Australia is part of?

Mr Macfarlane—I cannot conceive that getting off the ground. The countries are so different and there is no political will behind it anyhow, so I do not think there is any likelihood of that at all.

Ms BURKE—Some of the submissions have made some sort of suggestions about it being explored or looked at.

Mr Macfarlane—Yes, I know. The Japanese have sometimes talked about it. I have heard Hong Kong people talking about it, too, but I would put it in the realms of the highly unlikely.

Ms BURKE—Yes, thank you.

CHAIR—Can we come back to the question of the hedge funds and the Asian crisis?

Mr Macfarlane—Yes. Australia found itself in an unusual position during the Asian crisis (a) by being in the Asian region and (b) by actually understanding what was going on in Asia and I think understanding it a bit better than some North American and European observers. So we found ourselves in the position where we observed first-hand the activities of hedge funds in Australia, South Africa and Hong Kong. We were somewhat disturbed by what we saw and we mentioned this in various international forums, usually to relatively unsympathetic ears. We found ourselves very much on the side of our neighbours and felt they had a legitimate complaint to make about some of the activities of the hedge funds.

Even though typically at that time the official sort of organs of the world, the important institutions in the US, and the IMF, I think thought we were exaggerating or were crying wolf, I do not think that is the case now. Ric Battellino could explain more later. I think partly because we kept up the presentations on behalf of our view and the view of our neighbours, people in the US and Europe think there is some substance to our complaints. I think the single thing that did the most to switch them around to thinking that maybe we knew what we were talking about was the collapse of the biggest and most glamorous hedge fund of them all, Long-Term Capital Management.

I think when that collapsed – and that had systemic implications – it was important enough to actually cause the US Fed to change monetary policy. I think when that happened people realised there was something going on they should pay attention to and I think, as we will explain later, some things are being done. That is an overview of the hedge fund issue. I have to say as well that the collapse of Long-Term Capital Management actually took a lot of the pressure off. I think it punctured the reputation the hedge funds had. Hedge funds were able to be effective because they had an enormous reputation, all or most of which flowed from the collapse of sterling in 1992, which was attributed to the hedge funds.

People were saying, ‘Aren't the hedge funds powerful?’ and, even more worryingly, ‘Aren't they always right?’ Once they got this reputation it became very easy for them to borrow money and very easy to take big positions and very easy to get other people to imitate them, thinking that they are bound to make money if they do what the hedge funds do. So for a time they were quite formidable. But I think that is not the case now. I think with the collapse of Long-Term Capital Management and the fact that some of the others have done very badly and got a few bets wrong, some of them are now a lot smaller than they were, at least for the time being they have become a much smaller force than they were in 98.

Mr WILTON—Given that many of the large international hedge funds operate by attempting to influence the overall direction of the market, do you think the participation of those funds in Australia has in the overall brought positive benefits? Secondly, an equally general question, would you consider that there may be a need at some stage in the future of regulating the activity of hedge funds? If so, in broad terms, how might that regulation be achieved?

Mr Macfarlane—On the first point, in looking back now that the dust has settled, did they contribute favourably or unfavourably to Australia? Before I answer that I suppose I should say that hedge funds are only one of the players in this. One of the arguments we had put back to us when we talked about hedge funds – and it has some substance – was that people would say, ‘Oh, yes, but they're not as big as the commercial banks and they're not as big as the investment banks. They're really just small beer compared to these massive commercial and investment banks’ – and that is true. It is true but it was just that they could take very big positions and they could act very aggressively when they had this high reputation.

But we have to be careful that we do not attribute too much importance to them all the time, because most of the time the big players in the international financial system are the big international commercial banks, Australian banks, investment banks and corporate borrowers and big pension funds and all the rest. They are normally the big players. It is very difficult to isolate the effect of the hedge funds from the effects of these other big players. I think you probably can for 1998. You can look back, although our information, of course, would not stand up in a court of law because our information is hearsay. It is what the other participants in the Australian markets were telling us. I think during that particular episode in 1998, particularly in June 1998, their effect was harmful.

If they had been as successful as they would have liked to have been, they would have caused the Australian dollar to go down a lot further or caused us to put up interest rates to protect the Australian dollar and neither of those two things happened fortunately. But I do not think they would have been helpful if that had happened. That would be an example where by exaggerating the instability that was already there they could bring about a harmful effect. I think it did, for example, in Hong Kong initially. I think it did bring about a very harmful effect. They had a currency board, a very fixed exchange rate and it caused Hong Kong interest rates to go to incredibly high levels. That did contribute to the severity of the recession in Hong Kong.

I think in that particular incident they were definitely harmful. You will hear a lot of other people say – and there may be some justification for this – that on average over the long run they are not harmful, they are just another investor, they make markets a lot deeper because they are always in there buying and selling and they are contributing to turnover. There is some substance in that argument but I think, on average, if they were just another investor then that would be the correct interpretation.

There was a second part to your question: should they be regulated? We have an open mind on this. We are probably inclined to think it would be too difficult to regulate them and that you can probably achieve most of what you want by relying on disclosure rather than regulation. It is probably not, at this stage, necessary to go down the regulation path. I think that is our view. If we are wrong, if there is another great bout of instability in a few years time and we discover the hedge funds have become much bigger and they have caused damage in medium sized markets, then maybe there would be a case. At the moment we think enough is being done internationally in terms of re-examining their role and trying to improve disclosure.

One of the biggest problems was that the people who were lending to them did not even know what they were doing. The people who were lending did not know the risks they were taking and that is a very severe shortcoming of a financial market, to have respectable, prestigious banks lending to small, incredibly risky hedge funds and not knowing how big the risks were they were taking. The new approach to hedge funds is to cut off that supply of credit – a sort of unthinking supply of credit – by various rules on disclosure.

Could I ask Mr Battellino here, who knows a lot more about this subject than I do – he has been on working parties organised by the Financial Stability Forum and also by the Bank for International Settlements – to give us a summary of where he thinks the reforms of the hedge funds are heading.

Mr Battellino—Following the events of 1998 I think the international community looked at problems in two respects: one was to examine the relationship between hedge funds and the people who were lending to them, mainly banks, and the other was to look at the degree of disclosure that hedge funds submitted to. The first issue is important because even though hedge funds themselves are unregulated and not very important in the overall scheme of things, the banks that lent to them are central to the financial system. As Ian said, one of the problems was that because the hedge funds had developed such a powerful reputation and were putting so much business through the financial markets, banks were very keen to do business with them and lending to them on terms that demanded much less disclosure than banks would typically require of other customers.

We saw when Long-Term Capital came close to collapse that many of the firms that had lent to Long-Term Capital were not aware of the extent to which Long-Term Capital had borrowed from every other institution as well, so one issue was to look at business. So the Bank for International Settlements organised a group to look at the relationship between banks and hedge funds. They submitted the report in early 1999, which basically set out a whole range of things a bank should do in their relationship with hedge funds. That is in the process of being implemented at the moment.

The second aspect was to look at the degree of disclosure by hedge funds. Hedge funds had grown up very quickly in the space of a few years and so, like most firms that are developing quickly, the regulation fell behind. Most of these firms are located in offshore financial centres such as the Bahamas, so they are not directly under the jurisdiction of major financial centres. By and large, these firms were able to get away without disclosing any information at all, very little information either to clients or to the people lending to them.

The Bank of International Settlements, together with IOSCO, the International Organisation of Securities Commissions, got together a group to look at this whole question of disclosure by hedge funds and that has been progressed. At the moment the US has taken the lead on this because a lot of the hedge funds really are US institutions in the sense that even though they operate out of the Bahamas they are really operating in Wall Street where their offices are. The US has taken the lead and come up with a number of recommendations and a trial of disclosures is being implemented in the second quarter of this year. In the June quarter of this year a test will be done asking hedge funds and a range of other institutions as well to increase their disclosure. So we will find out over the second half of this year how successful that has been.

The US authorities, the US Congress, has also looked into this and at the moment there is legislation before Congress seeking to legislate to bring about laws to increase disclosure by hedge funds. Overall, I think the situation, if these changes go through, would represent a marked improvement on where the situation was a couple of years earlier.

CHAIR—Mr Macfarlane, just coming back to your comments about 1998, haven't we seen a more recent event in the last week or so where the Australian dollar seems to have been under selling pressure? When you raised interest rates, the fundamentals were looking good, commodity prices mostly were starting to improve and yet the Australian dollar has not only stayed where it is, in fact it fell quite severely one time.

Mr Macfarlane—There was a very unsettling incident last Friday week in New York, where the Australian dollar fell by about 270 basis points in a matter of three hours. That is very disappointing. It disappoints me a lot to see that can happen. It is the second time that has happened in the last three or four years. On both occasions the fall was basically based on speculation about a monetary policy decision in Australia and a monetary policy decision in the US. There is some talk about a west coast hedge fund being involved but I think it is only one of many players in that. Essentially in Australia I think a lot of people had been expecting a 50 basis point increase in interest rates at our board meeting, but then a couple of things happened on the Thursday and Friday that made them revise their expectation down to 25 basis points, the better than expected CPI being one of those.

The next day in New York suddenly some very strong GDP figures came out for the US and people did the opposite revision and they thought that the US, which they formerly thought would go up by 25, was now possibly going to go up by 50, and they thought that would lead to a widening in the gap between Australian and US interest rates. Our interest rates had been 50 basis points below theirs and they thought that would lead to a widening and so they got out of their Australian dollar positions, sold, and did it in a great hurry. That was based on sort of speculation about monetary policy in the two countries. It was disappointing that it had moved as far as it did, but I do not think we can attribute that to hedge funds. I think that was much more widespread.

CHAIR—Just on that point, you wanted to table some documents, didn’t you?

Mr Macfarlane—Yes, I have given you some documents. I do not necessarily want to talk to them. I just thought that our discussion might lead into areas where those documents might be helpful. I thought I might want to refer to them but we have not actually got into those areas just yet.

CHAIR—We can have them formally incorporated if you would like that.

Mr Macfarlane—I am perfectly happy to, yes.

CHAIR—We will have them incorporated as an exhibit in the hearings. So you are suggesting on that point it really was not the hedge funds alone that were –

Mr Macfarlane—No. It was speculation offshore, I think, that monetary policy in Australia may not do the right thing but, in my view, it did the right thing. But at the time there was some hesitation.

Mr PYNE—The role of the hedge funds in the Asian financial crisis quite rightly shone world attention on the international financial architecture in which we operate. In fact you have set out today answers to some of those questions I was going to raise about what role Australia is playing and what role other countries are playing in trying to organise some final arbiter to deal with groups that act outside the normal.

In this table you have given us today you have set out that Australia is involved in many of the groups trying to organise some sort of sense of financial architecture which perhaps would be useful. I am glad they are now incorporated as an exhibit. It is a very impressive list that Australia is involved with in comparison to most other western countries. How active are we in each of these fora? For example, are we the chairman of any of these fora? Do we have secretariats that deal with each of these fora, or is there one secretariat that deals with the whole lot? What are the responsibilities between the Reserve Bank and the Treasury? I know this is an area the government would like to capitalise on, given our good reputation as a result of the weathering of the financial crisis in 1998.

Mr Macfarlane—You have given me a few questions there. I want to go back through a bit of history. A lot of people in my position or in positions in Canberra have felt for some time that Australia did not have the influence in international affairs that it deserved, that we were in some sense underrepresented, we were underweight and we were sort of punching below our weight. The biggest single reason for this I think was an important international group called the Group of Ten, of which we were not members. I do not know the history of it. I do not know why we missed out, why we did not get a ticket into that club, but we did not. It was formed in the late sixties and it was very influential. It included, first of all, the G7; it has got the listing here.

No-one in Australia thinks we could get into the G7, we are simply not big enough to get into the G7, but I think we feel that we got mistreated a little bit in that we did not get into the G10, because at least three of those countries are smaller than we are. Switzerland, Sweden and Belgium are smaller than Australia and the Netherlands was about the same size. So we had a good claim to be in there and we were not. It turned out that G10 became relatively influential in a number of areas. For example, in the OECD, the most important meeting of the OECD is a thing called Working Party 3. We never got into that because we were not a G10 member.

Of a lot more importance, I suppose, over the last decade is that the whole structure of decision making on bank supervision was conducted through a thing called the Basel Committee which is physically located with the BIS. That was a G10 group as well. So, even though we implemented the Basel requirements and were a model in doing it, we were never actually in there making the rules. So we did not have a seat in a lot of these international bodies which were making the rules for the future. We tried very hard at various stages to get into the G10 and we never did.

Fortunately I think in recent years – over the last three or four years – and particularly in light of the Asian crisis, a number of the bigger countries, particularly the US, started to realise that G10 had outgrown its usefulness. It was ridiculous having important international rules being formed by a group that included Belgium, Switzerland and Sweden and did not have China or India or Russia or Australia or a lot of other important countries. So there has been what you might call a jockeying for position going on. The G10 is being downgraded and various other groups are being formed.

It is very important, we have felt – and I certainly know my colleagues in Treasury and Foreign Affairs and the Prime Minister and the Treasurer and others agree – it is very important that Australia not miss out this time. If there are going to be international groups that are making rules, we should be in them. The first attempt to come up with a group that was bigger than the G7 to do this was a group called the G22, which I have mentioned before in front of this committee, which I think was very useful but it was mainly a US initiative. In the end its composition could not get the approval of the Europeans and it only ever met twice. One of the two meetings was chaired by President Clinton. It was taken very seriously at a very senior level but it did not survive. We were on that; both the Treasurer and I were members of that.

What it has been replaced by are essentially two different groups, one of which is this thing called the Financial Stability Forum which initially was only a G7 group and did not have anyone else on it. Eventually they decided they should increase their membership and they added four countries. As you can see, the countries that they added were Australia, Hong Kong, Singapore and the Netherlands, so that was quite satisfying. That was 11 countries and it was the same size as the G10. As a footnote, I will have to say it was actually 11 countries. We were included in that. So I am member of the Financial Stability Forum which looks specifically at financial stability issues, so it has a relatively narrow mandate.

The other big development and the important one was – given that the G22 did not last, what would it be replaced with – it was replaced with a thing called the Group of 20 which at this stage is still in its infancy but

I think it will be very important as time goes by because, after the G7, the G20 will be the second-most important group of countries who can get together and discuss these issues and Australia is a member of that. We are a member of both of the two important clubs that have been formed in the last two or three years and we are treating our responsibilities extremely seriously. There are working parties and various groups and we are members of a number of those. Ric Battellino is a member of the working party on highly leveraged institutions or hedge funds, which has been set up under the Financial Stability Forum. I think this is a very good development. It is a sign that we have a higher standing in the world community than we had back in the days when the G10 was formed.

Dr SOUTHCOTT—Australia and the Reserve Bank gained a lot of plaudits for its response to the Asian financial crisis and the way it weathered it. What impact do you think the email going out from the Reserve Bank at 9.24 has had on the reputation of the Reserve Bank and also Australia as a regional financial centre? How far has your investigation gone into this incident and what checks will you be putting into place to prevent such an incident occurring again?

Mr Macfarlane—I think it has harmed the reputation of the Reserve Bank, I know that. I feel very embarrassed by it. I do not think it has had any effect on Australia's reputation. It was actually very small if you add up the money that was involved. It was a relatively small sum in the scheme of things but it certainly was a great embarrassment for the Reserve Bank. We have taken it very seriously . We have set up a committee to inquire into it, people who are outside of the information office – Mr Battellino is the co-chair of that committee and we will be reporting on what went wrong.

Actually we know what went wrong. We know a particular person made a mistake; pressed the wrong button. I take this opportunity of saying it is not the person whose name has appeared in the newspaper. The person whose name appeared in the newspaper is totally innocent. There were two people operating that machine and it was the other person who made the mistake. But we are looking into it, we will come up with a completely new set of procedures and we will make our inquiry public so anyone can read about what happened and what is going to be done to improve it.

I have to say in passing, too, that the error was basically caused – as errors often are – by someone trying to be helpful. It was not caused by negligence. It was by someone doing something beyond the call of duty to make the public happier by getting something a little earlier and in the process they made a serious error.

CHAIR—Mr Macfarlane, I want to come back to this question. You mentioned the disappointment last Friday week ago about the drop in the Australian dollar. There is always going to be speculation about your decision-making, but with the benefit of hindsight is there any way you could see of improving the lead-up to these decisions so that you do not have that problem? Clearly it is not in Australia's interests to see that gyration of the dollar and, as you say, it is disappointing and I am sure you try to avoid it. Is there some way in the management of decision-making you could improve?

Mr Macfarlane—I do not think there is anything we can do in the lead-up to a decision. It might have been a little better if there were less other people commenting on and speculating on it, but there is nothing we can do about that because we live in a democracy and people are allowed to comment and speculate and give their views. But I do not think in that period there is anything we can do about it. After the decision has been made, we can be as transparent as possible, but there is not a lot we can do in the lead-up.

CHAIR—You are concerned about the prominence that speculation is starting to gain in the media generally?

Mr Macfarlane—I am not sure that I am concerned about it. It is just a fact of life; we live with it. It happens in all other countries – people do speculate before a board meeting about what the outcome will be – but there is nothing you can do before that meeting to make it any better. You cannot get out there and say, `I think we'll probably do this.' You cannot pre-empt the meeting. You have to have the meeting and the meeting has to make a decision and there is really nothing you can do before it.

Ms BURKE—Do you think there is any credence then in people suggesting that the meeting should be more open and should publish the minutes of the actual board meeting, in line with what the US does?

Mr Macfarlane—A lot of people have made that suggestion. I do not think that would solve the problem that –

Ms BURKE—No, it will not solve it because it is after the event.

Mr Macfarlane—the Chairman is talking about, because it is after the event. We are open to suggestions. We do not think we have necessarily got the perfect system. We think it is a lot better than some people have given us credit for. In particular, we are much more open than any other central bank in publishing immediately the reasons why we made a decision. The US gets a lot of credit for publishing its minutes but they come out six weeks later. What they publish at the time is one very tiny paragraph and they did not do that until four years after we were doing it. One of the reasons they did it was because we did it. The former deputy chairman of the Fed was very impressed by the way we released, what is by international standards, the most detailed press release of the reasons why we have changed monetary policy.

Every country is different. Everyone is trying to come up with a set of arrangements which are transparent but, on the other hand, are not so demanding that they inhibit people from speaking freely and giving their untrammelled opinion. I am happy to hear other suggestions and we are certainly happy to countenance them.

CHAIR—On the question of transparency, you are obviously reasonably happy with what we have generally in Australia. But is there a point at which you can see that transparency becoming too much and having negative effects on liquidity of the markets?

Mr Macfarlane—There is an optimal amount of transparency and it is not necessarily just the absolute maximum. I had a quote somewhere from my esteemed counterpart in the US. He is subject to the most extreme transparency, with armies of people interpreting every word he says and comparing what he said on 4 July 1994 with what he is saying now. He has reached the point where he has said he has ‘learned to mumble with great incoherence’. He said, ‘If I seem unduly clear to you, you must have misunderstood what I said.’ There is an even greater one where he says – and which I have trouble even reading; I do not know how he got this one out – ‘I know you believe you understand what you think I said but I'm not sure you realise that what you heard is not what I meant.’

CHAIR—Does he think he is the oracle from Delphi or something?

Mr Macfarlane—He does not think he is the oracle from Delphi but people interpret his words with such detail that any slight change in a word between two speeches is interpreted as meaning something for monetary policy and it makes it very difficult for him. I do not think we have reached that stage but there is an optimal amount of transparency and probably in the US, through no fault of their own, media attention has taken it beyond that optimum.

CHAIR—In Australia's case?

Mr Macfarlane—I have an open mind. As I said, I think we make a lot of effort to be as transparent as possible. I certainly speak a lot more than my predecessors. They used to collect governors' speeches and bind them up in a volume and when they retired they gave them these as a farewell gift and kept one in the governor's office. If you go back to the earlier governors, you get a volume that is about a third of an inch thick and then it gets a bit bigger. Bob Johnston has got a decent sized book, Bernie has got two; we are going to have to give up that habit because there are just so many speeches now, so many papers, that if they wanted to do it for me I think we would end up with a whole set of volumes.

I think we have made a major effort. We take it seriously. We think that the trilogy of independence, accountability and transparency go together. There will always be people who want more. I think this committee has made a very important contribution to the transparency of the Reserve Bank. I think this is an important step forward; not necessarily referring to today's meeting, but the traditional twice-yearly meeting has been a very important contribution. But there will always be a demand for more, particularly from the press.

CHAIR—Yes. I can assure you all of us have probably had phone calls in the last week saying, ‘What more do you need?’

Mr WILTON—On the issue of transparency, Governor, do you have any comments in general on the recommendations by the Bank for International Settlements, its Committee on Transparency recommendations on transparency in general? Do you think those recommendations will help to obtain an effective method of measuring risk profiles?

Mr Macfarlane—I am not sure I fully understand the question. Tell me if I am wrong. There is a set of IMF guidelines on transparency for monetary policy –

Mr WILTON—There is.

Mr Macfarlane—which we have seen. We think they are very sensible; we meet those requirements without any trouble. I think it is a worthwhile exercise because, as you are probably aware, in some countries there is very little transparency in the central banks and, not only does it lead to confusion about monetary policy, it can often lead to very significant losses of money because they have been doing things that people are not aware they have been doing. We are strong supporters of the IMF guidelines on transparency of central banks.

Ms GAMBARO—Governor, I would like to ask you about countries in our regional area. Australia played a significant role a few years ago in assisting Vietnam to put together a constitution because they did not have a constitution, as did a number of other countries. Do you see a role for Australia to assist regional countries in meeting international financial standards?

Mr Macfarlane—Yes, we do – (a) we see a role and, (b) we are doing it. It is mainly on the basis of responding to requests. We cannot force ourselves on people but we are always happy to respond to requests. Dr Grenville has a very important role in that respect and he is on the Independent Review Committee that oversees the work of the Indonesian Bank Reconstruction Agency. As you can imagine, the Bank Reconstruction Authority is just about the most important bit of the Indonesian economic bureaucracy at the moment. Steve was asked to go on that, with two or three other people from other countries and he works on that. So, yes, we are certainly very happy to help.

Ms GAMBARO—Do you see our role increasing?

Mr Macfarlane—I think it has. We have had a lot of people in Thailand recently. As I said, we have had a lot of people in Indonesia. As a result of the Asian crisis and the fact that we were (a) so interested in it and we got through it so well ourselves but (b) we were prepared to speak up amongst the developed countries and say, 'Look, there are a few things you're doing that are wrong and aren't helping Asia,' our reputation has gone up. There have been cases where countries have been more comfortable turning to us for advice than, for example, turning to the US, even though the expertise is available in both places.

Ms BURKE—This is a very broad question. Can we ever regulate the international framework for finance, given what happens with technology, e-commerce, the Internet, the whole works? Is there any hope of doing anything about it?

Mr Macfarlane—That is a very difficult question. The Financial Stability Forum is working on the assumption that, if it gets good bank supervision, good supervision of insurance companies, it gets very good disclosure from central banks, good accounting procedures so people know what is going on, all this infrastructure right, the system will function; that is, it will have variations and fluctuations but it will be stable. It will not lead to contagion runs like we had in the Asian crisis. The answer is we do not know. Intellectually, no-one can say, 'We know when all these things are put into place, the system will still be stable.' It is possible that it will still be subject to booms and busts, as stock markets are.

Stock markets have the best disclosure in the world. The US stock market has the best disclosure requirements you could possibly hope for; America has excellent accounting standards. They have all the infrastructure. The banks are very well supervised. You still have booms and we hope we do not have too many busts, but you still have a history of very big swings in sentiment and no-one can be confident that any set of regulations or improvements in infrastructure can prevent that happening.

Ms BURKE—We cannot enforce it any way, shape or form. It is literally up to each country to say, 'Yes, we're happy to go with some form of systemic thing to ensure that our bank stays stable.'

Mr Macfarlane—Yes. Some countries, in an early stage of development, do not have to open themselves completely. We have never said they have to. There are some people who do that. We think at an early stage of development it may make a lot of sense for some countries to regulate the amount of capital inflow. Sometimes they just get swamped with it and so we think there are circumstances where that makes sense. It does not make sense for us because we have got past that stage but we think it does make sense. So we are not saying everyone has to become a fully paid-up immediate member to 'the complete free movement of the international capital club'. We are saying it takes a long time to get into that and each country should do it at its own pace.

Mr PYNE—Mr Macfarlane, just following on from Teresa's questions about the countries in our region, what is your assessment of the willingness of the countries in the Asian region, following the financial crisis, to contribute to a review of international financial architecture? I am thinking particularly of Malaysia in this respect.

Mr Macfarlane—The countries in the region are contributing as best they can. You are referring to the fact that Malaysia adopted a different approach and that it imposed capital controls for a year, which by and large it has got rid of. I do not see anything wrong with that. I think countries can choose the path they want to go down. If they want to go down that path and it is in their interests they can do so. If they want to go down a path that does not involve capital controls, if they want to use the more traditional IMF medicine, they can try that too.

I do not think in any way that Malaysia should be seen as some sort of pariah just because they chose that particular way of solving the crisis. I think it is very interesting that they did. It is going to give people a nice experiment to study in years to come, to see whether that was better than the path that, say, Thailand adopted. But I do not think there is anything hostile in them choosing that path.

Mr PYNE—Not just from the point of view of choosing that path in the past, but in the future do you think that the countries that were involved in the Asian financial crisis are all willing participants in the review of international financial architecture and are prepared to contribute to how that is going to be controlled in the future?

Mr Macfarlane—Yes, to the extent that they are invited. Some of them are too small to get into these various clubs that I have been talking about. Obviously, they were shattered by what happened to them and they are very keen to do whatever they can to make sure that is less likely in the future. The problem is a lot of these things take a hell of a long time. It is very easy to say, 'You should have a better system of commercial law and bankruptcy procedures,' but it might take a decade to develop that and then another decade to test it in the courts.

Some of these bits of infrastructure that we talk about, like accounting standards, commercial law, and bankruptcy procedures, in our own countries maybe took 100 years to develop. That is why I am sympathetic to them. It cannot be done overnight and, until it is done right, you have a certain amount of vulnerability.

Mr PYNE—At the Asia-Pacific Parliamentary Forum, which was a conference in early January of Asian countries, the United States, South American countries and others, it was very clear that Australia was really well regarded by the Asian countries as a sort of honest broker in many of these areas, and we were probably preferred to be turned to as opposed to Japan and the United States, probably because of the sheer size of those countries and the intimidation that sometimes brings about. Would you agree with that? Do you think Australia has a unique role that it can play in this particular venture?

Mr Macfarlane—Yes, I think we have a very important role. I do not know whether it is unique but it is an important role and that is why my own institution, for example, has been very willing to send people to get involved. We are a very enthusiastic member of these regional forums and we are also very happy to send people on technical exchange, or receive people over here for training. But you have to be careful how you do it. As I said, you have really got to respond to requests, you cannot just foist yourself on people.

Mr PYNE—But I think we will get more requests than some other countries simply because we are not of an intimidatory size.

Mr Macfarlane—Yes, I think some Asian countries are more comfortable working with Australians than Americans.

Dr SOUTHCOTT—Mr Macfarlane, amongst the central banks there used to be a view that monetary policy could do everything, and there was a dominant school which said that anything monetary policy attempted to do would be harmful, and now I think the dominant school of thought is that monetary policy does have a role but it should be circumscribed and addressed at one thing, namely inflation. Is globalisation affecting that paradigm in any way? We have seen over a period of 30 years a number of different schools of thought. Does globalisation have any impact on the role of monetary policy?

Mr Macfarlane—It is such an open-ended question; I do not know how to handle it. All the monetary policy thinking that we have, and monetary policy implementation that we have been talking about for nearly 20 years, has been based on a world, for us, of a floating exchange rate and completely free movements of capital. That really has not changed since 1983. We have been living in that world and the model that we have adopted is a medium-term approach based on inflation targeting because we believe the only way you can have long, sustainable expansions are if they are low inflation ones; the high inflation ones never last. I do not think that the underlying conceptual framework, once you make the step to a floating exchange rate and compete free movement of capital, has changed.

CHAIR—I might come back to a more general question. In terms of the impact of globalisation, what are the negatives you can see down the track in the next two or three years?

Mr Macfarlane—Globalisation is a massive subject. It is not just a matter of international capital flows.

CHAIR—In terms of the terms of reference here.

Mr Macfarlane—In the bit that we are looking at, which is a narrow slice of it, we are talking about financial markets and international capital flows; we are not talking about the really big picture about how the world changes. In terms of the narrow area that we are looking at, now that Asia has got itself back on its feet in the sense that it is growing quite well, even though it still has a very severely fractured banking system and probably has a whole lot of corporate work-outs that are going to take years to get through – but the Asian economies are growing – the interesting thing is how they are going to handle the phase when the money comes pouring back in, as it already is in some cases, particularly in Korea.

Some of our sympathy for the Asian countries is because we go back to the discussions we used to have with them in 1994, 1995 and 1996 before the Asian crisis. The central bankers from Asia were always complaining, 'We've got too much money coming in, too much capital coming in. What can we do to keep it out?' They wrote papers on the subject and we had discussions and meetings and all the rest, and always this was the problem. They were reluctant to give up their fixed exchange rates and in the end the fixed exchange systems broke, they collapsed and they ended up with a crisis.

I think one of the interesting tests over the next two or three years is how they handle it when it starts up again, because it is going to start up again. There is a lot of money to be invested and a lot of it is going to find its way back into Asia because Asia still has fantastic growth prospects. Will they be able to handle it better this time? It would be interesting to have a meeting on this subject in four years time.

CHAIR—There is nothing else you wanted to add on that – Australia's perspective?

Mr Macfarlane—No.

CHAIR—You raised, obviously, a very important point. What is the sort of spin-off towards Australia?

Mr Macfarlane—I think the good news for Australia is that Asia is back and growing again, with a question mark still about Japan and, of course, a question mark about Indonesia, but by and large most of our big trading partners are back and growing again. That is good for Australia. We can get on with developing the sorts of businesses and the connections with Asia that we were doing in the past.

Mr ALBANESE—Governor, a more specific question as to the impact of globalisation in policy terms: to what extent, as we are seeing an increasing internationalisation of the economy, do you see any prospect for international economic governance in the sense of proposals which have been floated but have never really got off the ground, say calling for an international transfer tax, the Tobin idea of 20 years ago that has come in and out? There has been some suggestion of a potential trade-off between taxation measures which have been requested by perhaps the underdeveloped nations and ILO standards and labour relations laws which developed countries have been concerned about. Do you think there is any prospect for real progress there?

Mr Macfarlane—These are the sort of bigger issues of globalisation that I alluded to. First, we would not support the Tobin tax. Whilst it would reduce turnover, we do not think it would necessarily reduce the big misalignments of exchange rates, so we are not supporters of a Tobin tax. The other issue you talked about though is the international harmonisation of taxation and I think there is a case for something there. I think there is a tax competition going on, countries competing with each other for projects or investment by, in some cases, probably promising almost no taxation. I think that is an issue; that is possibly one of the unfortunate spin-offs of globalisation. I do not know of any forum where that issue is likely to be addressed. I do not know that there is much more I can say than that.

I think, just to reiterate, that there are some very big issues of globalisation that involve things like taxes and regional developments and labour standards – all sorts of things like that. Other than recognising that they are very important, I do not know that I have a lot to contribute, so I think I will try and stick to the narrow terms of reference that this committee has.

CHAIR—You did not want to comment any further on the fiscal question and the pressures for more equal or similar tax scales and so on?

Mr Macfarlane—I have some sympathy with that. I think in the rush of development some countries are almost bribing people to come. With companies that should be contributing to taxes, they are getting ridiculous tax holidays and I think that that is harmful. I am not really an authority on that but I am prepared to accept that it has been happening and that it is not helpful.

CHAIR—Is it to Australia's detriment?

Mr Macfarlane—To the detriment of all potential receiving countries.

CHAIR—Mr Macfarlane, Dr Grenville and Mr Battellino, thank you very much for coming before the committee and, as always, thank you for your willingness to field any questions that come your way, whether or not they happen to be directly relevant to what we are looking at today. We also, of course, look forward to the semi-annual hearings on 22 May and they will be in Melbourne. The committee will now take a short break.

Proceedings suspended from 10.37 a.m. to 11.03 a.m.

ANDERSON, Mr Jason Leigh, Senior Economist, Australian Stock Exchange

ROCHE, Mr Michael Anthony, Executive General Manager, Strategic Planning, Marketing and Corporate Relations, Australian Stock Exchange

CHAIR—I would like to welcome representatives from the Australian Stock Exchange to today's public hearing. Thank you for coming. I remind you that the evidence you give at the public hearing today is considered to be part of the proceedings of the parliament. Accordingly, I advise you that any attempt to mislead the committee is a very serious matter and could amount to contempt of the parliament. The committee has received your submission No. 6 and it has been authorised for publication. Are there any corrections or amendments you would like to make to that submission?

Mr Roche—No.

CHAIR—Do you wish to make a brief opening statement before we proceed to questions?

Mr Roche—Yes, thank you, Mr Chairman. I will make an opening statement that, rather than goes over the same territory of the submission, reflects on some other relevant matters.

CHAIR—Please proceed.

Mr Roche—We are pleased to have this opportunity to discuss the effects of international financial markets on government policy. It is a vital topic with wide scope and, as a result, there is a diversity of policy-makers and market participants with an interest in its development. In our written submission we have made some general comments on the implications of globalisation for fiscal and monetary policy. The Australian government has used policy instruments to guide our economy through a period of considerable pressure from international financial markets. The Reserve Bank of Australia, whose evidence you have just heard, has demonstrated its expertise in the use of monetary policy.

Australia's recent history shows that the government has a set of key policy tools which can contribute to economic growth and the ASX certainly defers to the expertise of policy-makers who are responsible for implementing these powers. They are best placed to comment on the need for adjustment to Australia's financial regulations. ASX's overarching concern is that the committee finds that facilitating a flow of capital across borders with appropriate safeguards is a fundamental principle for government policy. Global finance is essential to the health of free markets and, thereby, to the economy as a whole. I hardly need to remind you that foreign savings are essential to fund Australia's investment requirements. Using Australian Bureau of Statistics data, it is estimated that between 30 and 40 per cent of investment in ASX listed equities is provided by non-residents.

To ensure the benefits from such activity, there must be appropriate safeguards which serve to stabilise the system. Adequate information for risk analysis for market participants is a basic requirement. In this respect, analysis of market participants by regulators plays a key role, as the ensuing approval – either formal or implied – provides the market with confidence in the integrity of the participants. In its role as a market supervisor, ASX has some important responsibilities for monitoring the financial health of parties to securities trading. ASX places capital liquidity requirements on all participating organisations or, as you would commonly know them, broking houses.

In general terms, the capital liquidity requirements require all participating organisations to maintain a specified minimum level of capital relative to the risks that they incur in running their business. Participating organisations have an obligation to monitor their capital liquidity requirements at all times and advise ASX if their requirements fall below certain specified levels. In normal circumstances all participating organisations are required to lodge monthly reports, but when necessary returns can be required daily or specific inquiries required to be answered. For example, ASX requested daily reports on capital liquidity as a result of the market correction in October 1997 and participating organisations were contacted following the announcement that Yamaichi Securities was in financial distress in November 1997. We note that these inquiries did not identify a significant exposure for any participating organisation.

ASX is in the process of introducing revised capital liquidity requirements for all participating organisations. Development of the revised requirements commenced in 1995 and involved extensive public consultation with participating organisations, regulatory authorities and other interested parties. The revised requirements have changed the focus of the capital liquidity requirements from a balance sheet approach to a risk based approach. This risk based approach will require participating organisations to consider the transactions they undertake and the implications of those transactions on their capital requirements in a different way to the balance sheet approach. The revised requirements became effective in May 1999 but are not compulsory until November this year. ASX has provided this 18-month transition period to assist all participating organisations to adopt the revised requirements and, hence, there are currently two capital liquidity rules operating.

The revised requirements mean ASX's rules are comparable with international standards on capital liquidity for securities dealers. The revised requirements have been accepted by ASIC and, as the need arises, it is worth noting that ASX may liaise on an informal basis with ASIC and APRA to discuss matters of common interest in regard to capital liquidity issues. ASX has assisted all participating organisations by producing a detailed handbook explaining the revised requirements. This handbook also includes a section on general risk management principles which ASX believes will assist all participating organisations in the operation of their business.

ASX is further assisting the adoption of risk management principles by establishing a separate risk management unit whose role is to undertake the policy development of risk management and prudential supervision across equities and derivatives. That concludes our opening statement, Mr Chairman, and we welcome any questions.

CHAIR—Thank you, Mr Roche. I thought we might start by asking questions on the hedge funds and the role of hedge funds. Do you, through the Stock Exchange, have any comments about the adequacy or otherwise of the regulations and legislation as it applies to hedge funds and, in particular, their effect on Australian currency and like things?

Mr Roche—As I indicated in our opening statement, we believe that other organisations such as the Reserve Bank and Treasury are best placed to make comment on the adequacies of the general economic policy's regulatory framework. We like to keep close to our own knitting what we know and what we have responsibilities for in relation to the capital adequacy and the regulatory side of our own work in financial markets. We do not really come here with big picture views, I am afraid, about the regulation of hedge funds.

CHAIR—What about the impact of them? Has there been a detrimental impact in terms of developing your capital markets or is it now at a manageable level?

Mr Roche—I would have to say that in our recent experience we have not observed a period where hedge funds have unduly destabilised Australia's securities markets. What we regard as an important goal for ASX is to ensure that our markets are broadly based so that we have a wide range of investors, domestic institutions, foreign institutions and, of course, as we have seen in recent years, the rise of the retail investor. A broad investing base provides stability for the markets, as does the sheer breadth and size of the market itself, the extent to which the Australian stock market is representative of the Australian economy.

CHAIR—You do not want to add any further comments on it?

Mr Roche—No.

Mr WILTON—Mr Roche, I understand you have deferred to others in regard to whether or not hedge funds should be regulated and the means by which that regulation might occur. But does the ASX observe in any formal way the modus operandi of hedge funds where they attempt to influence the direction of investment by initiating what has become known as the herd mentality? Whilst you might answer that that advantages markets by deepening them, is that the sort of deepening that the ASX really looks to in terms of being a deepening of substance?

Mr Roche—In any market you will see individual investors through to the largest international funds seeking to take advantage of where they believe there is a mispricing in a market. That is a feature of all markets and has been a feature of markets for the century or more that we have had formal stock markets in Australia. I can reiterate that we have not observed any undue impact of such funds in the Australian context. We would be concerned if any investor or participating organisation were to undertake market manipulation activities which are, in fact, contrary to Australian law. But that is really where we would have to focus.

Mr WILTON—Do you think the level of investment by Australian banks in hedge funds should be audited and reported on a regular formal basis?

Mr Roche—I think that is really something for APRA and the Reserve Bank to offer views on.

Ms BURKE—You do not think investors should know what exposure publicly listed companies have to those hedge funds?

Mr Roche—We have noted some comments from the SEC. I think they have been looking at the concept of disclosure, specifically about highly leveraged investments by publicly listed companies. We have very strong disclosure requirements in all our companies. If your question is should we have a specific disclosure requirement, that is something we certainly would look at if the committee felt it was worthy of pursuing.

CHAIR—Mr Roche, I will put the question around the other way. Do you see as detrimental to the operation of the ASX either to have or not to have this additional disclosure?

Mr Roche—Perhaps we have to identify who we are talking about. Our participating organisations are our responsibility in respect of their important role as intermediaries between investors and the marketplace and, hence, our role in capital adequacy requirements for participating organisations. I think the question was tending more towards looking at the role of ASX in its supervision of listed companies and our requirements there go to adequate disclosures to investors by listed companies. So how specific should we be in the range of disclosures that we set down? We have very strong disclosure requirements on the part of our listed companies. We do, from time to time, require listed companies to make specific disclosures; for example, in the run-up to Y2K we called on listed companies on three occasions to make disclosures about their state of preparedness. At this stage we have not seen a need for specific disclosure in relation to highly leveraged investments.

Dr SOUTHCOTT—The first of your recommendations suggested that the government focus on policy motivations behind financial market transactions, not on the magnitude of the movement. Would you like to elaborate on that? Are you suggesting the role of government is just to have sound economic policies and, if they do not have sound economic policies, that will be reflected in the market?

Mr Roche—I might ask Mr Anderson to comment.

Mr Anderson—I think the example we gave in our submission was of the depreciation of the US dollar against the Japanese currency and that it occurred as a depreciation of similar magnitude but over very different periods of time. So the question of policy makers is to say, 'What are the structural forces at work which you would want to have translated into prices?' as opposed to, 'What are speculative forces, or purely speculative forces?' The distinction between them is not very easy to draw. There is a continuum there.

I listened to the Reserve Bank Governor's comments this morning with interest when he said, 'We have some views on hedge funds but they are drawn from anecdotal evidence.' One reason for that is that the motivations behind market participants in terms of willingness to buy and sell is very difficult to determine from the regulator's point of view. What are you then left with? Are you left with a question of the magnitude of a particular transaction? Should that be a focus of policy? I think our position would be that no, it is not.

What you have to do is enable people to take positions and to have regulatory backup to the determination of those positions so that people are reasonably well informed about the risks they are taking. I guess there is a distinction between risk and uncertainty: risks are things that would be priced into market participants' decisions; uncertainty is ultimately something everyone has to live with. Governments determine what should be factored into risk and that is one thing we have taken a significant interest in with respect to capital adequacy. We are more interested now than we were a few years go in whether brokers are taking underwriting positions that put them at risk.

Are they taking positions with respect to forwards contracts which places them in a particular risk in the future rather than today? We are stretching out the boundary of what we consider to be important for the ASX's views on the level of risk that those participants take, but it is not defined by how much trading they are doing or what the magnitude necessarily of those positions are; it is the risk associated with the costs and benefits of any particular transaction.

Dr SOUTHCOTT—I see. In terms of speculation in the equity markets and so on, the government really has no role in that.

Mr Anderson—When you say 'speculation' do you mean the degree of investment, or do you mean the basis for –

Dr SOUTHCOTT—I am just basing it on your recommendations. Recommendation 1 deals specifically with speculation in financial markets.

Mr Anderson—Sure. I think there is obviously a range of areas where governments do influence the degree of speculation that people are willing to take. The monetary policy is a very crude but simple example of that, where the costs of investment are influenced on the investor's point of view, so clearly the degree of speculation that people are willing to enter into is important in that manner, but it is a focus perhaps on the nature of the risk rather than the size of the investment with which that risk is associated.

Dr SOUTHCOTT—Do you think monetary union involving the Australian dollar is a serious proposal?

Mr Anderson—That was certainly something we discussed in the submission we put in last year. It was primarily in the context of monetary union in Europe at that time, the financial crisis having led some Asian countries to set up research into an Asian currency. At that point it was considered worthy of some comment, but no serious consideration, I think. Certainly not from the exchange's point of view. I thought that the Reserve Bank Governor's comments this morning were quite apt in that it is not something that has been widely discussed or looked at in Australia.

Dr SOUTHCOTT—In terms of the reporting requirements for the Stock Exchange, there is already a certain amount of information available. What sort of reporting requirements do you think would increase the amount of information available in the market?

Mr Anderson—Reporting requirements by listed companies as well, primarily? Do you want to handle that?

Mr Roche—As I was saying before we, at the moment, are quite confident about the extent of disclosure that is required by companies in relation to the content of annual reports, half-yearly reports and, in the case of some companies, quarterly reporting – their requirements to disclose at any time events which a reasonable person would regard as having an impact on share price. I think going behind those current disclosure requirements is something we have not considered.

Mr Anderson—We have made some recent changes with respect to some specific types of listed companies.

Mr Roche—Yes, we are always keeping them under review. At the moment we have a rule out for consultation. Consultation closes next week and, subject to the results of that consultation, we would expect that what are known as cash rich companies – often technology companies with a bright idea and a lot of cash – would have to report not just in the annual reports but report quarterly on their use of that cash so that, for example, investors can be assured that when they invested in the company and they said they were going to invest in a particular software development, the cash is still being used for that purpose or, if it is not, they know where it has been used.

Mr ALBANESE—You say in your submission, to quote the introductory comments:

It appears that financial crises typically arise due to government attempts to influence capital flows for short-term economic policy objectives.

I am not sure how that fits in with the Asian crisis. I would be interested in your comments on that and perhaps, given that you were here this morning, comments on the Governor of the Reserve Bank's statements about the legitimacy of developing countries having some controls on capital flows.

Mr Anderson—I will take that question. It is a difficult area. I think neither of us would profess to be experts in the economics of what has happened in the Asia-Pacific. It is not an area of specific concern to the exchange. I think the comments in the submission were directed towards the use of fixed exchange rates rather than other dimensions of economic policy, although it is an overarching statement. Certainly the direction that we explored in the submission was fixed exchange rates. Certainly Mr Macfarlane this morning was extolling the virtues of having floating exchange rates and the importance of that has permeated all of our economic policy in Australia. But there is a range of policies, so you would not only talk about 'exchange rate policies'.

One way to perceive it is to observe the fluctuation in analysis that has come out of the major international financial organisations like the IMF and the World Bank where, I think in particular in the IMF, there was initially a position that there should be further deregulation as the solution to the Asian crisis. More recently, in the last couple of months they have put out a report saying, 'No, we accept that in some circumstances for short periods of time capital controls can be an effective policy tool.' There is a lot of conjecture and debate about those kinds of policies. But the comment in our introductory comments was more on exchange rates.

Mr Roche—I will just add, Mr Chairman, in relation to confidence of investors, local or non-resident in, say, an Asian country that may have experienced economic difficulties in recent times, where ASX believes there is a role for regulation it has been in the quality of the regulatory framework for the financial markets in those economies to give greater confidence to investors, perhaps to provide the confidence for return of funds or for less of a rapid outflow of funds. Through our network of MOUs with about half a dozen Asian exchanges, we have worked in multilateral bodies and bilaterally on assisting our regional exchanges with how they can further develop investor protection standards and how to best conduct derivatives markets and that sort of thing. We certainly see a role for improved levels of governance and investor protection and, I guess, the legal underpinnings of financial markets to provide greater confidence to investors operating in those markets. We believe that there is a role for Australia in that and we work with the department of foreign affairs where we can and, as I say, through our own bilateral and multilateral exchange to exchange networks.

Ms BURKE—Surely Australia has been an actual beneficiary of some of this because there has been investor confidence, because we actually have all those regulations here. Some people might say we are overregulated but, as the governor was saying, there is money around to invest and people actually looked at Australia because we had those protections in place.

Mr Roche—There is the safe haven argument, specifically reminding ourselves that Australia represents 1.2 per cent of world global capitalisation. Leaving aside Japan, the rest of the exchanges in our region do little more than double that total capital as share of world capital, so when a fund manager in New York or Frankfurt is making a decision about allocating some funds to our region, I hate to say it but sometimes the grain is not as fine as 'Australian telecommunications' or the like, it is 'Asia-Pacific'. I think that is something to avoid.

What we did notice, at least for a while, was that Australia suffered collateral damage in the eyes of some investors by being part of a region under stress. I think Australia can be congratulated, though – over time – on getting the message across that we did stand apart and we had a lot of strengths going for us. Over time probably it did tend towards more the safe haven argument. Nevertheless, we do believe we have a vested interest in the world seeing our region as a stable region for investment. We err on the side of assisting rather than sitting on our hands and taking some short-term benefit from another economy’s difficulties.

Mr WILTON—You think then that the ASX does have some responsibility to our regional neighbours in assisting them to monitor the financial health of their exchange players?

Mr Roche—To be able to tell them what we do, what we think works, to provide training. We have had occasions where exchanges have sent a team of people and we have had a teach-in at ASX to just sort of hands-on show them how we do things. Not everything is immediately transferable to their markets but we do try to provide that assistance, that is right, and we take that responsibility very seriously.

Mr WILTON—Is that assistance manifested in more active ways? Are your participants on any of their committees or –

Mr Roche—As I say, we are a member of what is called the FIBV, which is the international stock exchange federation, but we also have a regional stock exchange grouping called EAOSEF and through those bodies we do participate on a range of committees that target specific areas where we can have a transfer of best practice from, say, an exchange like the ASX to regional exchanges.

Mr WILTON—Is that a role basically that you would see expanding over time as the ASX gains a reputation for being a reputable adviser to our regional economies, that you would formalise your involvement in their developing exchanges?

Mr Roche—Sure. I suppose we have to keep remembering that ASX is also a commercial entity with shareholders but, within that constraint, we do certainly see a growth in the number of requests for ASX to provide assistance and training and transfers of best practice. Whether or not that will continue to grow, I do not know. It was certainly a factor in the wake of the difficulties in some of the Asian economies, where some exchanges in the region suffered very badly with a loss of listed companies and a collapse in market capitalisation.

CHAIR—Mr Roche, in your submission you made a recommendation about the need for recommending a detailed analysis for the reporting requirements of relevant financial institutions to be undertaken in order to assess whether an improvement of reporting requirements rather than regulatory measures is preferable. I take it from that that you must feel there is something lacking in reporting requirements and I wonder if you could give us a bit of an outline of what that is.

Mr Anderson—Again in reference to the work that was being done in the US that was just published prior to the submissions were due for this inquiry, coming out of that was a recommendation that the SEC develop requirements for public companies to report their exposures to other leveraged institutions. That is not something that ASX would initiate on its own. The analogous body in Australia is ASIC with respect to the SEC. I think one way of viewing that is, did we have any instances of publicly listed companies suffering materially as a result of exposures to other leveraged institutions during the Asian crisis, and there were none that we were aware of.

That is not to say that there is not a need for such information. Presumably, the purpose of these kinds of reporting requirements is to avoid problems rather than to close the door after the horse has bolted, but we had not pursued any active liaison with ASIC to investigate that, because we were aware that ASIC and the RBA were participating in an international forum where that form of requirement would presumably be discussed, and so it is really up to ASIC to determine the need and the nature of that particular requirement, not ASX.

CHAIR—Now eight months later, have you any other views you want to add to what you said then?

Mr Roche—We would say that nothing has occurred in the intervening period that would cause us for our part to go to ASIC and say, ‘Hey, I think we need to add another layer of reporting requirements’ over and above the ones I have described, the general duty of disclosure for our listed companies.

CHAIR—You also talk about the frequency of reporting. I guess you have to always get a bit of a balance on these things because the more frequently you are asked to come to report, obviously the more onerous becomes each reporting, and I suppose to some extent it could be detrimental to the day-to-day management if it has to report too frequently. Likewise, on that point, what were you really pushing for? What sort of outcome would you have liked to see or would you like to see on that?

Mr Roche—Correct me if I am wrong, Jason, but what we were getting at it is that we should take stock of current reporting requirements to assess whether or not they were adequate to capture any perceived issues that regulators may see in relation to exposure to highly leveraged investments and, rather than assume that we needed another layer of reporting, let us make sure that we are confident that the current set of regulations is not adequate.

CHAIR—For the committee's benefit here, could you give us the benefit of your wisdom on the matter and whether or not you think it is needed?

Mr Roche—At the moment there is nothing that has been brought to our attention, either by ASIC or through our own dealings with our marketplace, to suggest that there is such a requirement, but we are very open to hearing the views of others and participating in a discussion about that.

Ms GAMBARO—Just picking up on reporting requirements and disclosure of Australian companies, I have had a few episodes – and probably it is a little outside the scope, but I would still like to ask you this – of unsuspecting investors being offered shares in overseas companies. One case was a company whose prospectus was prepared in the UK but it was a Dutch company and it resulted in someone coming to me with a problem where $70,000 worth of the individual's money, I am sure, is never to be seen again. Whose role is it to provide information to consumers? Is it your role or ASIC's role, particularly with companies that are not listed or licensed to trade in Australia? It is ASIC's role to do that?

Mr Roche—If you are talking about an entity listed or operating elsewhere that is not an ASX listed entity, certainly that is not an ASX role. ASIC has broader investor advice and protection roles in there. It is probably something you should take up with them.

Ms GAMBARO—I have. It takes a long time, though.

Mr Roche—Sure. What ASX has observed is that there is an appetite on the part of Australian investors to diversify their portfolios. We seek to facilitate that through making sure the Australian stock market is as representative of the Australian economy as is possible. We also are growing a retail interest rate market so that investors can get access to fixed interest more readily than they can perhaps at the moment, and that is a sensible diversification decision. A further dimension of diversification is access to foreign equities. However, what we have in mind are linkages with other exchanges, linking in with that other exchange's regulatory requirements, making sure the exchanges we are linking with operate in a very sound regulated jurisdiction, such as the US or the UK or the like. That is always our preference. We would be very loath to be a vehicle for Australian investors to go into an inadequately regulated environment. Other than that I would say, 'Buyer beware.'

Ms GAMBARO—Just on another issue, greater disclosure and again on the disclosure issue: are your disclosure requirements greater for different categories of companies, particularly volatile IT companies, that are wanting to float or list? I will not quote the company, but recently a company made several attempts to publicly list and was rejected because it did not meet your criteria. From a perspective of companies floating, how do you work this out? Three unsuccessful attempts and they are out? Or do you keep saying to them, 'Look, we don't have enough material. Come back to us again'? How does it work, or do you require greater disclosure? You mentioned some of the risk categories before.

Mr Roche—In terms of getting listed there is a range of tests under which a company can be admitted to our market, and the disclosure that we are talking about at that stage is principally a disclosure in prospectuses, which have to be lodged with ASIC. ASIC can raise concerns about a prospectus if it so wishes. ASX can raise its own concerns about the adequacy of information for investors at that stage. It is not a case of three strikes and you're out or whatever.

Ms GAMBARO—Can a company repeatedly attempt to list? Can this process go on?

Mr Roche—I am not aware of a company that has –

Ms GAMBARO—I will not go into the company, but it has been over a couple of years that it has tried to list.

Mr Roche—We have a process for providing advice to companies where we will peruse their documentation and give them advice on the listing process and their listing documents in the run-up to their attempting to list. After they list, we have instigated – as I was referring to earlier – a proposal for reporting that is more rigorous for what we would call cash rich companies where they have raised funds, say, in an IPO and with indications in their prospectus of how those funds are going to be used, subject to the results of the consultation on that listing rule change. We would expect that from around March we would have those companies reporting quarterly on their use of those funds, which is a new requirement.

Ms BURKE—Is there actually any hope of regulating the people trading and buying nowadays? It is the same sort of question I asked the Governor of the Reserve Bank. With the explosion of technology, the Internet, day trades, all the rest of it, the whole market opening up and who can get in and out, is there any hope of ensuring that there is regulation going on?

Mr Roche—We would like to think so. We commit substantial resources of ASX to our market integrity function. We regard market integrity as core business for an exchange, so we have a very sophisticated surveillance department that monitors unusual activity in the marketplace. One of the strengths of the system we have is that those investments still go via an intermediary and so we have someone to go to immediately – that is, the broker who entered the order. In our surveillance department we know which broker, which operator at that broker entered that order, at what time, at what millisecond, and what was happening around that particular order entry, that particular trade, so we have the ability to watch what is happening and to follow up very quickly. There is no doubt that the activity on the market is growing very rapidly and that is keeping us on our toes in terms of making sure that we maintain that capability up to the mark.

Ms BURKE—What if they are not using an intermediary or not using a broker, which is becoming more the growth at the moment?

Mr Roche—Sure. Your comment reflects the success of the advertising push by some of our new participants on our market. It does not matter what they call themselves, they are a broker, and they are all subject to our business rules, our capital adequacy requirements, our surveillance requirements, so it does not matter whether you enter your order through Internet at home, through what was called a straight-through process, through trading into clearing and settlement. We can monitor all of that and that intermediary is playing an important regulatory role in our market of entering the trade, and that is where we go if we think something has one wrong. It is the broker, whether or not they call themselves a broker, who is taking on those responsibilities in the Australian environment.

Mr WILTON—At what stage are there any amalgamation discussions between yourselves and the SFE? In the event that that were to materialise, would that new, larger and presumably more powerful body see a greater role for itself in lobbying for, say, a particular regulatory regime?

Mr Roche—In relation to ASX's interest in merging with the SFE, that ran into the immovable object called the ACCC, so at the moment we have no proposals afoot to reopen that particular question. That said, we have a long period of cooperation with the SFE on regulatory matters. For example, we have worked with the SFE on aspects of the Corporations Law reforms, in particular what is called CLERP 6, which we are expecting the minister to make some announcements on at the end of this week. We have mutual interests of a regulatory nature, and our mutual interests certainly go to the quality of regulation. Irrespective of the ownership linkages, we would continue to work closely with fellow exchanges on regulation issues.

Mr WILTON—I want to turn to another subject. What do you see are the major impediments at the moment to Australia developing as a serious regional financial centre? We are one now, but I mean the one that everyone has been talking about.

Mr Roche—We have done a hell of a lot in recent years to address some of the impediments, and they go to issues of tax: the capital gains tax changes recently approved by parliament certainly make us a more competitive environment; the scheduled removal of a range of state financial taxes. Particularly, from our point of view, the stamp duty on share trading is to be abolished from 1 July 2001. It removes a tax that many of the competing markets in our region do not have. They are all very helpful measures.

The whole tax reform push has been a great plus, and the new efforts, with the appointment of Les Hosking as the head of a centre for global financial services, is certainly going to be a very important part of promoting Australia. Getting Australia on the radar is not always easy. As I was saying before, when you are 1.2 per cent of world global capital it is not always easy to get yourselves on the radar of the decision-makers. I think that is where a lot of it does go to; it is scale and volume. One of the reasons we were seeking to merge with the SFE was in fact to have that scale for Australian exchanges to be a more significant player on the world stage. A lot of our efforts will continue to have to go into lifting this scale of Australia's operations.

CHAIR—We seem to have covered a fair range of things there. At this stage we might adjourn the proceedings. Thank you to Mr Roche and Mr Anderson very much for coming along and thank you for your submission as well. The committee will adjourn until 1.30

Proceedings suspended from 11.52 a.m. to 1.31 p.m.

STARR, Mr Malcolm Douglas, Director, Legal and Compliance, Sydney Futures Exchange

CHAIR—I would like to welcome Mr Malcolm Starr from the Sydney Futures Exchange to the public hearing. I remind you that the evidence that you give at the public hearing is considered to be part of the proceedings of parliament. Accordingly, I advise you that any attempt to mislead the committee is a very serious matter and could amount to contempt of parliament. The committee has received your submission, numbered 9, and it has been authorised for publications. Are there any corrections or amendments you would like to make to it?

Mr Starr—No, thank you, Mr Chairman.

CHAIR—Do you wish to make a brief opening statement before we go to questions?

Mr Starr—Yes, Mr Chairman.

CHAIR—Please proceed.

Mr Starr—Thank you. The primary focus of the exchange's contribution to your committee's work has been on outlining how existing controls in place in well-managed derivatives exchanges reduce the risk of one user of such an exchange being adversely impacted by the default of another user. We recognise that in the absence of any suggestions that such controls need to be reviewed, the committee's primary focus may, in fact, be somewhere completely different from this – maybe on other issues. Nevertheless, we were encouraged to see the committee identify at the outset of this inquiry as one of its roles enhancing understanding in the Australian community of those parts of the financial infrastructure which do in fact work well. We agree that the committee's role is not confined to recommending change in areas where there was arguably scope for new controls.

Our submission indicates why the mere fact that a user of a particular derivatives exchange has incurred exposures which may warrant quite legitimate concern about that participant's ability to meet its obligations should not of itself be a cause for concern on the part of other users of that exchange. Certainly, if one or more of the direct participants in the exchange has such a concentrated exposure to a highly leveraged customer that the customer's default could cause the direct participant through whom it dealt to default, then those impacts could in theory be transferred through to other direct participants and through to their customers in turn. I use the term ‘direct participants’ to cover those with whom the exchange has a direct relationship – that is, the members, in the case of a mutual organisation like the Sydney Futures Exchange.

In practice, it is the capacity of exchanges to identify and monitor this concentration risk and then rely on things like margining to address this risk which constitute the real safeguards against excessive leverage creating systemic problems in exchange markets. I would be happy to elaborate on those controls which address this concentration risk if the committee wishes.

At the exchange we have not been party to any of the discussions in the various international fora looking at these financial stability issues over the last few years. Accordingly, we are not ourselves in a position to assist the committee as to the stage that those discussions may have reached. For our part, we have simply joined with many others in expressing some reservations about proposals for increased disclosure and direct regulation of hedge funds which were under discussion when this committee's inquiry was being launched. We remain sceptical that increased public disclosure by corporations of their exposures to highly leveraged entities is a practical direction or even necessary to reduce the amount of leverage being used by some of the counterparties to major financial institutions. Again, I am happy to explore this in further depth if the committee is still treating this as a live issue. Thank you, Mr Chairman.

CHAIR—Thank you, Mr Starr. On that last point, yes, we would still consider it to be a live issue and, because of the fact that you even raise that question, you might like to expand on that point, but also on the question of why you doubt the need to increase the public disclosure by corporations that do have that exposure, and we might explore this in some depth.

Mr Starr—The issue that I was adverting to there was that at the time that this committee was established there were various proposals identified. Particularly, for example, the President's working group in the United States produced proposals whose underlying rationale appeared to us to be that if one required all major corporations or all major financial institutions, or some grouping like that, to indicate the extent of their exposures to highly leveraged institutions, however one defined that, then that in turn might cause the boards of those organisations to contemplate reducing their exposures to such highly leveraged entities, and therefore if in fact that practice became widespread, there would in fact be nowhere for those highly leveraged entities to find counterparties.

In expressing scepticism about whether there is a need for additional disclosures, that amounts to a comment on our part that we did not have any ideas of our own as to how we would like to see accounting standards increase the considerable disclosure that already exists as to this type of exposure. The second element of the scepticism related to the difficulties in relying on the snapshot that accounts necessarily provide and therefore forms the view that the real hard work of assessing whether important financial institutions that should not be allowed to fail is adequate is a task for prudential supervisors. That is an area where we are saying there may well be considerable scope for prudential supervisors to finetune their particular mechanisms, but increased disclosure does not seem to us to be necessarily a promising solution.

CHAIR—In terms of the trading of the hedge funds and so on, do you have any evidence since you have prepared your submission that there was any adverse effect there to the detriment of other people who trade in the currency or use the currency for their trading purposes?

Mr Starr—We have certainly not identified any in relation to participation in our own markets. We are aware that funds that would no doubt meet any definition of 'hedge fund' are users of our market, as they are users of most exchanges around the world. We do see the names appear as customers of our members, and we do on a regular basis have cause to satisfy ourselves that our members do not have excessive concentration to any one client, be that one client a hedge fund or anyone else. The answer to your question is no, we have not identified any new problems.

CHAIR—So you are saying you can ensure that there is no concentration with one client. Did you say that? I did not quite catch your last comment.

Mr Starr—We cannot ever rule out absolutely the possibility that a dangerous concentration will arise, but we do see one of our primary compliance and surveillance functions to be to make sure that it does not arise. We do that by, for example, receiving reports as to who are the customers on whose behalf our members deal and we see the size of those positions. If, for example, there was a client who appeared to constitute a large proportion of the client base of a particular member, then it would depend on the financial strength of that member as to whether we would feel a need to take action to require them to reduce that concentration or we have powers to increase the margins, for example. We cannot absolutely guarantee that a member will never take on an exposure to a client that we would regard as too high.

CHAIR—Has that happened in the past?

Mr Starr—Yes. We would certainly find situations where we can see an exposure which we think could be dangerously high and we would undertake discussions with the member, with a view to ascertaining their intentions.

CHAIR—But has that happened in reality and how often would that happen? How often do you have to use the powers that you are talking about?

Mr Starr—I cannot recall in recent years ever, for example, increasing the margin requirement because we felt the member did not have enough capital to withstand that exposure. No, those powers have not needed to be used.

Mr PYNE—Mr Starr, would you accept that there is a negative perception of hedge funds in the community?

Mr Starr—I do not know whether that remains a current one. I would certainly accept that there probably has been and that probably still remains. I would expect that the term is one that many people in the community would have great difficulty articulating, what they actually had in mind when the expression 'hedge fund' was used.

Mr PYNE—Do you think one of the reasons for the negative perception is because of the mystery surrounding hedge funds?

Mr Starr—I would have thought that it is not the mystery surrounding hedge funds but in fact highly publicised events involving organisations such as Long-Term Capital Management nearly failing. That in the recent past is a more obvious example of something that has generated concerns about hedge funds.

Mr PYNE—Do you think one of the reasons for the concern about hedge funds is a lack of accountability, transparency and disclosure?

Mr Starr—I do not deny that there may well be those concerns.

Mr PYNE—You have suggested there should be a regulator to look at its own methods of regulation with respect to hedge funds in Australia. Is that what you suggested before: there should be an Australian regulator that should investigate aspects of transparency, disclosure, et cetera?

Mr Starr—No. We have in fact not made any recommendations for change at all. We have confined the focus of our submission to being able to assure the committee that, within the area of activities which occur on organised exchanges, there is already an adequate set of controls.

Mr PYNE—Your submission is that there is an adequate set of controls currently in place in the international financial architecture to deal with hedge funds.

Mr Starr—No. My answer was in relation to the participation of hedge funds in exchanges. We do not ourselves put forward any proposals for further regulation, either directly of hedge funds or of the relationship between banks and hedge funds. I am expressing no view as to whether there are a series of other problems outside of our province which may require resolution. I am not suggesting that there is no need to do anything in relation to the regulation of hedge funds.

Mr PYNE—This committee is reasonably interested in finding out the views of experts in the field about what they think we should be doing with respect to international financial architecture. I am wondering if you have any ideas about how to change the international financial architecture in order to perhaps get a closer rein on hedge funds.

Mr Starr—We are fully aware that there is always scope for finetuning the capital charges imposed by prudential supervisors on that range of institutions which are subject to prudential supervision; in Australian terms APRA supervised bodies. We do not regard the fine detail of how those capital charges might be finetuned as an area in which we have any specific recommendations and we note you have heard from the Reserve Bank. That is one possible area where some adjustments may or may not be necessary. On the question of whether there is value in directly creating new laws in Australia that purport to require greater disclosure by hedge funds themselves, then we have expressed the same scepticism as many others as to whether, in fact, that would be a type of regulation easily avoidable and not actually achieving the desired outcome.

Mr PYNE—So most hedge funds – in fact, perhaps all hedge funds – are not subject to APRA?

Mr Starr—I have skipped over until now the question as to what a hedge fund is. There are vast numbers of funds, nearly all of which are already regulated by ASIC under Australian law, by virtue of any collective investment. Hedge funds clearly usually fall within that notion of collective investment. The hedge fund terminology tends, in an American context, to come back to US regulatory definitions as to which types of hedge funds, because of the sophistication of their participants or whatever arbitrary thresholds are used, are not subject to quite as much of the regulation that ASIC imposes on other funds. Australia is consistent with the US and other countries in applying that approach right across the board in its regulatory framework, be it in the area of prospectuses, fund management regulation or anything else. There are exceptions from the requirements to make disclosures to persons who are assumed to have the requisite knowledge to form their own judgments. Hedge funds tend to be an example of a fund that fits into those exceptions and, no doubt, some of them would do so in Australia and some would not.

Mr PYNE—Thank you.

Mr WILTON—Mr Starr, you have indicated, of course, that you think one of the benefits of hedge funds is that they increase the depth of markets. That may be so, but should it not be a concern in particular to policy-makers that, as well as positioning themselves to take advantage of expected market development – and there is nothing wrong with that – these funds at times try to influence the course of those developments? I want to refer to the RBA paper, which you would be familiar with, on the impact of hedge funds on financial markets, where it gives in relation to the Australian experience of 1998 in regard to the exchange rate an example of a 'destabilising' – its words – impact that hedge funds can have. It says that:

> The circumstances of hedge fund activity in that case involved a more aggressive stance as the exchange rate approached its post-float lows of around US60c at a time when the market was naturally quite sensitive. Key features of hedge funds activities were signalling to other market players that they were about to attack the Australian dollar –

a move which, of course, would have heightened uncertainty and deterred potential buyers from remaining within the market and this would, of course, have lowered the offer prices among brokers, even though they were able to sell all they had on offer at the existing price and concentrating sales into periods of thin trading. It concludes by saying:

> A consequence was that exporters who had been keen buyers of Australian dollars at high levels not only stopped buying but began to sell at that time, in the expectation that the exchange rate would fall even further – a classic case of the so-called 'herd' mentality. Is that not a reasonable example in recent times on the local front where hedge funds are pretty destabilising?

Mr Starr—We have no disagreement with any of the passage of the Reserve Bank's submission which you have just quoted. It should indeed be a matter of concern to any market when attempts are made to manipulate the prices, whether those attempts are made by a hedge fund or anyone else. We explicitly have prohibitions against that type of activity in the existing Corporations Law in relation to manipulation of the prices on an exchange market. I think the Reserve Bank itself probably acknowledged in that same submission that, therefore, the area – if there is an area of concern – is how does one address it if that manipulation occurs in respect of instruments outside of exchange markets.

It is relatively easy to define the concept of market manipulation for exchange markets like the one that we operate, where the offence of market manipulation is trying to move prices away from their fair value and you have, at any one point in time, the price at which a particular instrument is traded. Therefore, massive buying or selling activity directed at moving things away from that price constitutes an offence and much of our surveillance activity is directed at trying to anticipate the building up of large positions which could, in fact, be used in an attempt to manipulate the prices. You are perfectly correct in saying any attempt to move prices away from fair value and giving rise to the sorts of consequences that you mentioned is something that we should be concerned about.

Mr WILTON—What evidence do you have that that is not an ongoing and regularly occurring practice amongst hedge funds?

Mr Starr—I do not have any evidence either way on that score.

CHAIR—Mr Starr, is there a risk that if you do get that instability – you said, I think, in your submission that the impact is restricted to currency but, in fact, many traded goods are relying on the Australian dollar's value, so the impact is obviously considerably greater. It could be multiplied many times. What impact do you assess that has on Australia's general ability to trade? I know it is a broad question.

Mr Starr—Yes. I should clarify. The reference to currency markets in our submission was simply to note that a considerable amount of the concern publicly expressed at the time our submission was being prepared was in relation to hedge fund activities in certain currencies and we were simply making the factual observation that we did not have contracts that explicitly had currencies as the underlying instrument. As I have indicated in response to the previous question, it does not matter what the instrument is. It is important not to have manipulation of markets, so I accept the proposition you are putting that this is potentially a very important issue.

Mr WILTON—Do you feel you need to express in your own words what a hedge fund is? That is something you alluded to before and I thought you wanted to do it but had not been afforded the opportunity.

Mr Starr—I was simply saying that a hedge fund in my terms is no more than a fund which has been granted an exclusion under existing laws from some of the obligations applicable to other collective investment vehicles. What I am saying by suggesting a definition along those lines is that hedge funds are really just a creature of regulation. If you want to characterise hedge funds as not being a creature of regulation but they are funds which happen to invest in particular instruments or happen to have a certain type of practice, then I am happy to accept anyone else's definition.

I am simply saying to you if, as a committee, you are trying to identify problems with the activities of some funds and you are attempting to come up with solutions as to what your new controls would be directed at, you are essentially going to come back, I would have thought, to broad-brush propositions that say your concern was about something like manipulation and you therefore do not need to identify who is the target – it is anyone who manipulates, is what you are trying to get at – and therefore the debate about hedge funds is irrelevant; or, if you have a concern about the members of hedge funds not getting information then you need to focus on how inconsistent that is with the entire panoply of securities regulation throughout the world; or, finally, if your concern is that certain accumulations of funds can be so large or that they can involve such sufficient excessive leverage then presumably your solutions will be directed at exposing amounts of leverage. That is a longwinded way of saying you have to identify a different class of people that some new control would be imposed on, depending on what the ill is that you are trying to overcome.

Mr WILTON—Mr Starr, again digressing, you alluded briefly in that answer to the notion of regulation and your submission makes the valid point that national regulation is inappropriate, given the flight of these funds to international markets. Do you see the level of international regulation, as it has occurred to date – if it has really occurred at all – as being somewhat patchwork?

Mr Starr—It is a not a description I would use, no. I would have said that by virtue of the number of international forums like IOSCO, the banking supervisors group, Financial Stability Forum and the like, more and more we are finding that domestic regulation is actually being generated by those international fora and each parliament is, in fact, progressively finding that they are putting in place laws that are consistent with principles emerging from those international fora.

Ms BURKE—Then in broad-brush terms our reference No. 3, the relevance to these issues of recent developments in the international framework for financial regulations, are you trying to say that – like others have alluded to – it is almost impossible to have international regulations of some of these systems?

Mr Starr—I am saying it is very difficult to purport to have domestically focused regulation that catches international activities if one does not rely on use of international fora to establish consistent domestic regulation. I do not have any particular view as to whether there is scope for giving more direct authority to some international body to become an international regulator.

Ms BURKE—Regulator, yes, if there would be any actual hope of them then saying to individual countries, `This is how you are going to now operate in the global financial market.'

CHAIR—Does the futures exchange take any active role in encouraging other countries to take up some of its regulation? In Australian you obviously feel we have a fairly good set of regulations. Do you get actively involved in international fora or individual countries?

Mr Starr—Yes, we do. Our participation in the International Organisation of Securities Commissions as an associate member, for example, by virtue of our exercise of self-regulatory functions is one example of a vehicle where we have some input. Realistically, it is difficult to suggest that the input of self-regulatory organisations into organisations like that is very great. It is essentially an organisation of the government funded statutory regulators but that is the only forum to which we have access in which we can and do put forward our views.

Mr WILTON—Just on the issue of regulators, what are the implications for financial regulators given the rapidly increasing speed of transactions and settlements? When these functions are undertaken simultaneously how will that be regulated? Do you have any sort of notion as to how that might occur?

Mr Starr—I do not have one generic answer that fits every instance in which there is an international dimension to a regulatory problem. I simply recognise, as all regulators do, that there are difficulties and one must attempt to overcome those difficulties by methods like mutual recognition of the practices of other regulators and a series of steps like that.

Ms BURKE—Is there a need for greater transparency about what information the various exchanges are now going to be operating with –more disclosure of information, et cetera?

Mr Starr—We would have difficulty thinking of another exchange that is more transparent than ourselves. The essence of a centralised futures exchange is that the prices that are traded can be seen on, quote, `vendor screens' around the world within seconds of when the trade occurred, so we have not been giving much thought to whether there could be even more transparency than is evident in our own market.

CHAIR—We talk about: when there are some difficulties, does this pose a real threat to the integrity of our market or is that something you feel we have managed to ride through? At what stage do you get concerned when, say, the dollar drops 3c or something?

Mr Starr—I do not have any views to express on that subject. I certainly share your underlying assumption that a massive change in price of any instrument is cause for inquiry as to whether that was the result of a new fair value being established or whether it was the result of something untoward. Certainly, as indicated earlier, that is a large part of our function, of making sure we identify instances when something like that occurs to make sure that it is not someone attempting to manipulate the market. So, yes, this is a market integrity issue of importance.

CHAIR—I think we have covered a fair range of issues there.

Mr Starr—Thank you.

CHAIR—I thank you very much, again, Mr Starr, for coming before the committee. We will now call the next witness, Dr Currie.

[2.08 p.m.]

CURRIE, Dr Carolyn Vernita, (Private capacity)

CHAIR—I welcome Dr Carolyn Currie to today's public hearing. I remind you that the evidence you give at the hearing is considered to be part of the proceedings of the parliament. Accordingly, I advise you that any attempt to mislead the committee is a very serious matter and could amount to a contempt of the parliament.

Dr Currie—I am here as a private individual. I am not representing the university for whom I work or my own private company or anybody else.

CHAIR—Thank you. The committee has received your submission No. 3 and it has been authorised for publication. Are there any corrections or amendments you would like to make to your submission?

Dr Currie—No, but as mentioned, I will be adding some significant evidence.

CHAIR—Would you like to make a brief opening statement?

Dr Currie—Yes.

CHAIR—Please proceed.

Dr Currie—Firstly, just to summarise the paper, I have mentioned that the implications of globalisation of the international marketplace for Australia have become very evident in recent months but have been corrected in many aspects; some require further work. One is that the lack of information about capital flows was pointed out to Charles Freeland by myself in August 1998 when I was trying to access a database to do a study. During that we discussed setting up a database, which has since been done. I am not going to attribute it to me. The IMF, the OECD and the World Bank have a wonderful database on levels of debt and capital flows. Also, since then, they have introduced core principles for good governance, prudential supervision, and there are compliance audits which are now conducted by the World Bank, sometimes under consulting contracts and the IMF help is dependent on somebody satisfying the compliance audits. If they do not input data into the database it is pointed out to them they may not get help during a crisis.

A lot of the things I mention in my paper have actually been corrected since it was written. The aspects I think meritorious of still mentioning are: (1) that there is regulatory confusion – if you look at page 1, I have tried to summarise the number of different regulators that exist on a world stage; (2) the most important aspect of hedge funds which, according to my reading of the evidence, has not been emphasised is that they have arisen from a black hole regulatory arbitrage and the majority of large players are incorporated in tax havens.

The reason I was in London was because I was invited by Mr Freeland, who is Deputy General of the Basle Committee of Supervisors, to attend the Commonwealth Business Council, which is the Commonwealth of Nations gathering together of all the Reserve Bank governors. There was not an Australian represented, except me. What I found interesting and I think must be pointed out was that Lord Cairns in his opening address actually offered financial incentives to these tax havens to comply with the core principles of secrecy – drop the secrecy, drop the tax haven status and comply with their supervisory obligations under the Basle Committee of best practice in return for funding to set up other sorts of industries.

The reaction I gathered was one of scepticism: ‘Why should we give up our prestigious tax haven status?’ These very large funds play between the regulatory regimes. They are exempt from supervision because they are incorporated in a tax haven status. That is a problem pointed out to me when I was in the Federal Reserve at Washington, which is that they cannot supervise them because they are outside their regulatory rules and that Greenspan saw it necessary to rescue them because of the large amount of loans that are made to these hedge funds.

As evidence, albeit anecdotal, while I was in Hong Kong in 1998 visiting the Hong Kong Monetary Authority, because they were interested in looking at my system of compliance monitoring, one of the hedge funds was approaching Citibank for $20 million to do another play on the Hong Kong stock market which, through the interest rate controls, affects the Hong Kong dollar. So there is substantial evidence which you could gather that these funds can influence dramatically the currencies.

But the point I want to make in this paper, which I have done in sections 1 and 4 and it is summarised over the page in the table, is that the Asian crisis was really a crisis in prudential supervision and bank lending practices. They borrowed two years fixed interest and lent to high-risk enterprises, often with government directives. A careful audit of the prudential supervision by Standard and Poor’s, and Moodys, and careful risk rating according to a proposal which I am now marketing, would have listed these countries as having very deficient prudential supervision, plus very deficient reporting of bank data, plus very deficient reporting generally at the corporate level. So they were vulnerable to borrowing in the wrong method, lending in the wrong method and then to a hedge fund for making a play on their currency.

The reason Australia has withstood it is that since the 1990s we have developed considerable expertise in credit assessment, asset liability management, corporate governance and our exchanges and regulators have outperformed the market, so in fact if you statistically look at the number of so-called hedge funds that are incorporated in Australia I do not think you could actually come up with a traditionally highly levered hedge funds because, by their nature, they are usually incorporated in these Cayman Island type of tax havens.

To summarise the points I wish to make in terms of recommendations, and they also relate to us as a financial centre, while I was in Singapore I observed large government funding to set up Singapore as a training institute. If you get into the financial stability forum, you will find courses advertised to train central bankers. This is as a result of the Asian crisis. Australia, rather than being a lead manager, when we have the best prudential supervisors in the region, has got nothing going in this area. I myself tried to set one up at university. There is one running in Kuala Lumpur, which probably is not the best place to teach prudential supervision, and one running in Singapore. It does require government funding. It cannot be funded on a commercial basis.

So, firstly, we needed a training institute in the area of prudent bank management and prudential supervision. Secondly, I think Australia should be very pro-active in clamping down on these tax havens. Thirdly, we should be pushing for risk rating loans to hedge funds at a higher capital adequacy rating, and that is a way to beat them dead in the water without disclosure, because if your loan to a hedge fund is risk rated at 200 per cent, which the Federal Reserve did with LBOs back in the eighties to kill them, then those hedge funds –

CHAIR—LBOs?

Dr Currie—Leveraged buyouts. Then those hedge funds have to act in a more prudent manner. The final point I want to make is if you look at the regulatory set-up in this area there is a very important role that the Asian Development Bank should be making but has not been making. Having visited that organisation as an ex-bank internal auditor, I was fairly shocked at their controls, their choice of consultants and the supervision thereof, and I would only ever make private submissions on that; that a lot of the funding was not going to increase the financial expertise. Since the crisis the BIS has directed them very heavily to set up for instance professional standards for bankers. Now, we have already done this with our Australian Institute of Banking and Finance. There is no need to reinvent the wheel. But they will not, because of the way the ADB is set up, access our expertise in this area.

The ADB could be a channel to increase the financial expertise in the area so that you minimise the risk of crises, just as Australia has. When I was there in October 1998 they were recruiting somebody with expertise in banking. They were still only going to have one person out of all their staff, and I wanted to make that point because if you look at the regulatory controls you now have the IMF and the World Bank acting in conjunction with the BIS as monitoring agents. They are collecting information on these countries and monitoring and trying to bring them up to best standards. However, the ADB has an important role in providing funding for education.

The other organisation that provides funding, AusAID, I have worked for in Beijing when I was on a project, and I believe I can mention that I was involved with the People's Bank of China and MOFTEC in training. The continuing need for training in the area is very evident and I believe that I will say it is now handling it in a more concise manner, but previously they were outsourcing to the extent that you might have three or four consultants going right down the line with each taking a profit share, and the training was not hitting the market.

The biggest risk to us as a country is now in China, in the financial prudential supervision of that country and as it liberalises and comes on line, so I believe that a priority for Australia is taking a lead role in imparting our financial expertise, which I believe is considerable within our banking community. Australia has come a long way since this committee was first empowered to look at the banking industry.

CHAIR—Thank you. Dr Currie, I might start the questioning with that last point. You said the biggest risk to Australia now is in China. Would you be willing to expand on that point?

Dr Currie—Firstly, they are a nation of close to a billion people, with considerable financial resources. They did liberalise very rapidly in areas and allow companies to invest. They are now reformatting their banking system and moving with a lot of help from the EC and from the US Federal Reserve. When I say the risk, they are a significant trading partner, that destabilisation of their currency can affect the rest of the area, and what people do not realise is that Japan was in decline from 1988 onwards. Their capital adequacy was not adequate. It was only two per cent, when in 1988 the BIS wanted eight per cent. However, there are no disciplinary mechanisms against a country as wealthy as Japan to enforce that they follow prudent accounting disclosure and capital adequacy procedures. They are now doing that.

The Asian crisis, although exaggerated by poor bank lending practice, prudential supervision within Asian countries, the role of the hedge funds, the role of the banks in lending short, was really due to a long-term decline of trade with Japan, and a similar trend could develop in China. We need to see China as a growing market and we need stable currency there. If, for instance, their banking sector liberalises very rapidly in response to entry into the World Trade Organisation and liberalises the way the Asian economy is liberalised, which was borrowing too much and directed lending, it would obviously destabilise this entire region.

Dr SOUTHCOTT—If a country does not meet its capital adequacy requirements, won't financial markets impose a discipline on them?

Dr Currie—Well, they did not on Japan, you see, because of its huge surplus, and what we have now realised is that the amount of information provided to lenders was deficient. We now have the IMF, OECD, BIS, World Bank web site which you can get into through any of those organisations, which now supplies a lot of data on these countries. The world is far more educated as to the importance of capital adequacy but the market does not always discipline. We do not have an efficient market in the strong sense.

Dr SOUTHCOTT—So it acted irrationally in the case of Japan?

Dr Currie—Yes, because to continue in the sense that these banks were basically bankrupt – there is a little book put out by Ito et al, published by the Economic Institute in Washington, which details the capital and post-reconstruction and you only have to look at the extent of bad and doubtful debts, $650 billion, growing, throughout the Japanese economy to realise that you have an economy with some very strange weaknesses within it. Don't forget a lender may lend to a prosperous company but overall the banking sector was supporting companies that were exporting at a price that was below the cost.

Dr SOUTHCOTT—And how would you propose that a mega-regulator would enforce the capital standards?

Dr Currie—It is very difficulty with countries to enforce except there are a lot of ideas that float around the market; for instance, deny access to SWIFT. That could be catastrophic. It is a transfer system. The best way is as proposed by the US Treasurer, Rubin, which is exposure through disclosure, and the IMF has proposed publishing reports of countries that do not comply. Obviously it is very hard with countries like Japan and China, one, to get access to the information in the case of China and, two, the ramifications politically of publishing such reports. But the IMF has said that it will undertake to do this.

CHAIR—Just getting back, where you were talking about the banks, to this question of risk, surely in the case of Japan don't the banks have some sort of government backing, implicit or otherwise.

Dr Currie—Yes, they do. We have had seminars presented all around the world. The public sector in Japan is actually bankrupt. The private sector has the assets. A lot of the assets are held abroad. Because the banks are now being supported by the government, the government has a problem. The response would be either to print money, which causes hyperinflation. The problem in Japan, too, that affects us is that a lot of the older people are hoarding and most of their population now tends towards the older and they have the largest mature age population in the world. They hoard their money within savings accounts and that means there is not spending and that impacts back on Australia. But there are steps being taken by the Japanese government.

CHAIR—So when you say they are hoarding, you mean they are leaving it in savings accounts, not –

Dr Currie—Savings accounts which are not touched, which are not lent out, not like a bank. If you put money into a bank it is lent out. It is almost like putting your money into a safety deposit box. But it is not Japan so much that concerns me. Australia can play a role. Although we are a small country we have developed expertise in the area and often it only requires, for instance, a few good consultants to train the trainers and filter down. This is an area where we need to look carefully at the programs done by AusAID and by the ADB, make sure they are coordinated, that there is not double counting and not perhaps competition between various consultants that AusAID uses, that the ADB is actually functioning the way it should be functioning.

CHAIR—Is it the wish of the committee that the submission be accepted? There being no objection, it is so ordered.

Mr WILTON—Dr Currie, just to ask a nub-type question, do you think that hedge funds should be regulated in a similar way to other mutual-type funds? If so, how, and if that were the case how would you deal with those funds which were headquartered offshore?

Dr Currie—Most of the big players are headquartered offshore and we have two prongs to this. When executives are remunerated on the size of their loans to emerging countries and a hedge fund is dealing in emerging countries so therefore they are remunerated on the size of their loan to the hedge fund, you have a problem. That is up to each nation to deal with. The Bank of England has had a seminar on executive remuneration within banks and the way it should be done.

The second problem is that where these countries are excluded because they are incorporated in tax-free status, this becomes an international regulatory problem requiring a forum, particularly with the BIS and with the IMF and the World Bank, because the World Bank is in charge of poverty alleviation and a lot of these hedge funds have had disastrous effects. So they have to get together and look at the capital adequacy. The only way to actually regulate them, if tax havens will not give up their tax haven status and give up the secrecy provisions and comply with the Basel core principles, is for the Bank for International Settlements to say, 'Any loan to these entities must be risk rated 150 per cent.' Then the loans will become less attractive for the banks and it is the only way you can do it.

The second prong Australia could try is to join forces with the Commonwealth Business Council, and I do not know why we have no representative of the Reserve Bank there, in trying to persuade these tax haven statuses to come into the full financial world.

Mr SOMLYAY—Obviously there is a cost to revenue involved in setting up a hedge fund in a tax haven. What is the linkage between Australia and a hedge fund? If we are regulating to protect the revenue, for instance, are there revenue implications for Australia or other countries of these hedge funds setting up in tax havens?

Dr Currie—There are, in the sense that we forgo tax because they are tax havens and, although we have ways, if the parent or somebody is receiving income from Australia. But a lot of the investors can, for instance, go through an intermediary vehicle, have an exemption from tax through widely held debentures, so there is a revenue forgone. This is why the governors of these particular tax havens were laughing at Lord Cairns because they are living in London full-time and they are not prepared to give up their status. So the only way really to shut down these tax havens is by some concerted effort through the banking community to stop them lending to any entities that are incorporated there.

Mr SOMLYAY—What is the advantage to an Australian bank dealing with a hedge fund in a tax haven?

Dr Currie—Firstly, I do not know whether any Australian bank does. The informal feedback I had that the involvement of Australian banks in these sorts of entities is minimal. This is something your committee has far more power to find out than I. If an Australian bank did lend to a hedge fund, the advantage would be, because the hedge fund is trading at high risk and getting very high returns, that they get above normal interest payments and somehow or other they may be able to manipulate some of the tax rules if they are using a branch or an intermediary vehicle. So they could be possibly paying minimal tax. I am not sure whether any Australian bank is doing this; I have no statistics.

Mr SOMLYAY—Which Australian entities are?

Dr Currie—I am not sure whether any Australian entities are. There were international banks that have Australian branches. Bankers Trust was renowned as being one but it has now been taken over by Deutsche Bank and what I do not know is how much they were using their branch here. The references we have to movement of moneys is mainly due to international banks. It seems to be really those banks that have been caught out more by the Asian crisis through their exposure to hedge funds – a lot of US banks.

CHAIR—Following on from Mr Somlyay, how really can you regulate it? If an Australian company or individual has assets offshore, if they place them in the Cayman Islands or wherever it is, there is nothing Australia can do about it, is there?

Dr Currie—When the money is remitted back here under the AUSTRAC act, any amount over $10,000 is reported through. That goes to the tax department and the tax department is your best monitor of how it is done. But moneys can be sent through a variety of entities and also kept overseas as well and then made available, if you are a bank, to another branch, et cetera. Banks have ways and means of moving funds like that. I really want to make a disclaimer: I do not know of any traditional Australian bank that is involved in this scene. But we have suffered in the sense that we are not sure whether a lot of the plays on our currency are due to these hedge funds.

Mr SOMLYAY—So we do not really know, if the hedge fund fell over, how it would affect the ordinary person in the street.

Dr Currie—In Australia? If an Australian bank had lent to them and therefore had to write off the loan. But from what we know about the Long-Term Capital Management hedge fund – and I was actually in Washington where I was pointing out to them they really should take the Asian crisis seriously, because at that stage they were not. I had a discussion paper I was presenting, and the paper was presented in Basel in Switzerland and in London and in Washington. At that stage they thought it was really a regional crisis. But then within the space of my stay it became very evident that it was going to affect a lot of US banks through the hedge funds. Australia would then know.

If the Australian banks then had to write off a lot of money, interest rates would go up. There would be an effect on the economy and, I would say by deduction, Australian banks were not involved because we did not have those effects. The only way we are affected is that we are part of Asia – the hedge funds had an effect in Asia. For instance, when I went overseas – I do not know whether it was because I was going overseas – the Australian dollar fell to 55c, and somebody said it was hedge funds.

Mr PYNE—Do not go overseas again.

Ms BURKE—I just want to go back to this idea of training that you have been pointing out as something that we could lead in. The governor this morning was saying along those lines that Australia could only assist those countries when we have been asked to do so, that we cannot foist ourselves upon our Asian counterparts and say, 'Here we are. We've got the best regulation. Look at us.' We can only provide that information, that support, if a country has come to us to ask.

Dr Currie—Sure.

Ms BURKE—What I am gathering from what you are saying, is that we should actually be more active than that?

Dr Currie—There is the Financial Stability Forum web site that advertises courses. We do not have any courses advertised, we are not organising any courses, so no courses, no horses. If we advertise a course we have some problems, (1) visas, because often when we advertise a course and we want to bring in officials from Asia, we have a problem with the department of immigration saying, 'Well, they'll probably stay,' and (2) there are air fare levels, and (3) our cost of living. But if we advertise it and we get participants, maybe the government could subsidise those aspects and give special consideration for expediting the visa.

Ms BURKE—Why couldn't we do them offshore? We have 101 universities now located offshore in Asia.

Dr Currie—The whole point about Australia as a global financial centre is that we want the financial centre to migrate here. For that to happen we have to do a few things, which is equalise our tax with the regimes, equalise the incentives offered to relocate here and equalise our visa and air fares. So we defeat the purpose by running the courses in Hong Kong. Sure, we can do it, our universities are already doing things like that, but where you want to bring in expert regulators, there are not too many really good prudential supervisory regulators who can train – and I am quoting from Charles Freeland – their time is limited. It is better to have the people come here and be able to observe the way the system works.

Mr WILTON—You mentioned before – just to digress again on to something else – that when you were in London at that Commonwealth forum Australia was not represented?

Dr Currie—Business council, yes, which is Commonwealth of Nations.

Mr WILTON—Just to extrapolate to the nth degree from that observation, do you think that Australia is being effectively represented in international forums which are examining international financial structures?

Dr Currie—No, only by academics like me. No, I do not. I was at PACAP which is a very high-calibre forum, where they had all the central bankers from the region come and make presentations. The person representing us was the ambassador who actually got stuck and I helped him out. So no. Where are our people? I know we have funding cuts.

Mr WILTON—Where was this?

Dr Currie—There was the Financial Management Association. It is the largest professional association in the world and their sidekick in Asia is called PACAP, Pacific Asian forum, and they organised a South-East Asian central banking forum. This was in July 1999, where I presented a paper and there was no Australian Reserve Bank person there except the ambassador.

Mr PYNE—Dr Currie, this morning the Governor of the Reserve Bank, Ian Macfarlane, presented us with a table that shows that we are a member of the G20, the Committee on the Global Financial System, BIS, the BIS Gold and Foreign Exchange Committee, the Financial Stability Forum, APEC, EMEAP, the Manila Framework, the Six Markets Group, the Four Markets Group.

Dr Currie—I realise that.

Mr PYNE—Then a number of working groups of the Financial Stability Forum.

Dr Currie—But I am saying, when you have a conference you go and you see a lot of Federal Reserve, you see Bank of England people. In the old days you used to see Reserve Bank people there. It is very good in the Asian era to have representation. These are high-level intergovernmental agency conferences.

Mr PYNE—The Reserve Bank Governor gave evidence this morning that in fact Australia was doing more now in financial fora to do with international markets than ever before.

Dr Currie—Right.

Mr PYNE—He was very proud of that fact. Your evidence shocks me.

Dr Currie—In what sense? I just said I was at the Commonwealth Business Council and there was nobody there from Australia.

Mr PYNE—No, because Mr Wilton said to you did you think the Australian government was doing enough, and you said no.

Dr Currie—No, I thought the question was, ‘Do you think Australia is adequately represented?’

Mr WILTON—That was the question.

Dr Currie—Yes. And I said no. As far as doing enough, I think there are ways and means in which we could be effective. One is that AusAID sometimes is running several programs that contradict each other, and I cannot talk about that because I am a consultant sworn to confidentiality and this poses problems for the Australian Embassy. Two is that we are funding the Asian Development Bank and yet I think we need to review how that money is being spent in terms of raising financial expertise. Three is that we should look at helping get programs going that can go up on the Financial Stability web site, facilitating the entry of people in here to come and be trained in that area. So I believe we can do more in a more effective way. As far as representation, it is just a matter of fact that you do not see very many Reserve Bank people any more, or APRA people at conferences where there is interaction.

Mr PYNE—It is possible of course the Reserve Bank does not think that those conferences are worth attending.

Dr Currie—That may be so but the Federal Reserve and other regulators send their top people to them. I mean, when you have all the governors of the South-East Asian countries together, I would have thought that would have been a very good forum for a Reserve Bank or APRA person to be.

Mr ALBANESE—You have spoken about tax havens and the problems that they create.

Dr Currie—Yes.

Mr ALBANESE—You also, in answer to a previous question, were speaking about the need for basically lowering our tax rates so they are equitable with taxation rates overseas if we are going to compete in terms of the idea of Sydney being a centre for a global market. Those two things raise the question of taxation at an international level, and whether that is possible. I would be interested in your comments of whether it is (a) desirable and (b) feasible, I guess is the difficulty which is there.

Dr Currie—What is that – desirable?

Mr ALBANESE—Whether it would be desirable to have –

Dr Currie—To equalise tax rates?

Mr ALBANESE—No, to have some form of international regulation/taxation regime. For example, the idea of a financial transfer tax, the Tobin idea, or there are other measures which have been floated around – whether that is a good idea or not?

Dr Currie—I think it is a good idea. The point is, who would levy it, who would collect it and how would you divide it up. The easiest way to levy it would be through SWIFT because they do all the international transactions between countries. But the matter of then apportioning where the revenue goes or whether the revenue goes into the regulatory framework. What I am trying to put in my paper is at the moment we have the BIS who has evolved from being a reparations bank into setting prudential standards and doing a very good job, and coordinating and evolving with a marvellous web site. We have the IMF which is more a lender of last resort, and the World Bank that allocates money for poverty alleviation, and we have the ADB.

If the world decided, yes, we will collect money on these transactions and that can be a way of trying to dampen down the tax haven status, because they will have a lot of tax that is collected from them, and that money will then be allocated to the regulators on a needs basis to help fund their ongoing activities, I think, yes, why not look at that idea? As we evolve with globalisation and we coordinate our accounting standards, our governance, our prudential supervision, we certainly need to look at coordination of tax and revenue sharing. It is part of globalisation.

Ms BURKE—Do you think our current prudential regulations are adequate just internally inside Australia? You made some sort of reference in your paper about concerns that that is where crises start from?

Dr Currie—Let me just say APRA is a new creature. They have not been examined by this committee – I do not know why. Have they?

Dr SOUTHCOTT—We do have that as part of our brief.

Ms BURKE—We do.

Dr Currie—If I could just make comments that are observation comments because I was invited to talk at the Financial Service Authority and I have watched its evolution. I was in from the incorporation in June 1998 when I met with Carol Sarjeant, head of banking supervision, and went to the offices down near the ex Irish bomb site and went back a year later and gave a talk. They have moved very rapidly. They have put out a number of books, for instance, *RATE,* on how to supervise. They have a huge web site, huge information disclosure, rapid recruiting, seminars going. They want London to maintain its lead role as a financial centre. When I went to APRA I have to say I found most of the people in the research department had resigned. I think they have recruited again. There were not the same booklets. They are now moving. I gave a seminar and I was asked, 'Why regulate?' I just thought a stupid question needs a stupid answer – 'Why do we have traffic lights?'

I thought the body needs cohesion because you are absorbing a number of cultures. It needs training, it needs people to put through regulatory theories. I was also told, 'Don't bother about ratios for analysis, they are dead.' But the only way the Federal Reserve and the FDIC analyse banks is by looking at bank ratios. So I have to say I am very disappointed with the operation of APRA. I do not know whether it is going to be able to cope with the superannuation funds as money flows in. Obviously my comments do not apply to the Reserve Bank.

I am told that just as the Reserve Bank of Poland keeps a very strong eye on their separate prudential arm, that the Reserve Bank here keeps a very strong link, particularly through Dr Laker, but it is of concern to me that they do not have any public exposure. To quote Professor Valentine, 'I don't know what APRA does. I don't know whether they are doing anything. All I know is I don't think the capital adequacy rules they are looking at are going to be able to cope with the effect of credit problems or another market downturn in derivatives.' I think this committee should have a look at APRA.

Ms BURKE—So you were not then in favour of the Wallis recommendations with the establishment of APRA?

Dr Currie—I have to say that if you read my evidence to this committee back 10 years ago, you would find that I am the one who recommended the formation of the separate supramega regulator for prudential supervision, insurance and funds. So, yes, I was, since it was my idea, although a lot of other people claim credit.

Ms BURKE—You just do not believe it is actually operating in the way you believe it should be.

Dr Currie—Because they do not have enough public disclosure, they are off budget and they collect money by levying fees from banks. I think that possibly there is too much of a culture of 'Since the banks are paying us, let's please the banks.' I am very outspoken on this but I do believe that APRA should be subject to the same disclosure, public scrutiny that the Reserve Bank is getting on monetary policy but it does not seem to be happening.

CHAIR—Dr Currie, this committee has a standing reference to get APRA before it. If you feel you have a strong case you would like to put to the committee we could certainly follow that through.

Dr Currie—All right, I will try – it is really anecdotal, just by watching the FSA evolve and seeing a highly professional unit like a commando unit really move full on into the market and start disciplining and charging fines for bad behaviour, and some of the fines they have levied have been quite horrific. Then I went to APRA, rang them up and I got a strip recording. It was a phone message of a lady stripping. I did say to the girl, 'Do you think this is entirely appropriate for a prudential supervisor?' There were no bomb checks, there was no security and when you are a regulator if you are full on, you have to watch your security. People can go in and take your files for one thing. If you go into the FSA you really get checked. I thought I was going to be body searched at one stage.

CHAIR—We do have a standing reference.

Dr Currie—All right. I do not know whether you want something in writing, other than this. I was told that when I gave evidence 10 years ago I was very unpopular with the banking community, particularly with one particular bank, Citibank, and they had a go at me. I do not particularly want to have APRA having a go at me.

CHAIR—I just mention that in passing. I think we have covered quite a range of issues there. Dr Currie, thank you very much for coming to the committee today.

Dr Currie—You are welcome.

CHAIR—And thank you for your written submission.

Resolved: