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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

Monday, 13 March 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, Mrs Hull, Mr Latham 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 9.07 a.m.

HENRY, Dr Kenneth, Executive Director, Economic Group, Department of Treasury

HORNE, Dr James, General Manager, Macroeconomic Policy Division, Department of Treasury

JOHNSTON, Mr Gary, Chief Adviser, International, Department of Treasury

O'BRIEN, Mr Terrence, Specialist Adviser APEC, Department of Treasury

O'MARA, Dr Paul, Specialist Adviser Forecasting, Department of Treasury

SPINDLER, Ms Karen, General Manager, International Finance Division, Department of Treasury

CHAIR—I declare open this hearing of the House of Representatives Standing Committee on Economics, Finance and Public Administration's inquiry into international financial markets. This is the second public hearing for this inquiry, which is examining the effects of the 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. Other important aspects of the inquiry are to review information requirements for the stable and efficient operation of international financial markets and to examine the relevance of recent developments in the international financial architecture to Australia's situation.

The witnesses we have here today play an important part in Australia's involvement in international financial markets. They are from Treasury, and we will also be hearing from witnesses from the Department of Finance and Administration. We are very interested to hear the evidence that will be given today, so we will move immediately into procedures for calling witnesses. I welcome representatives of the Treasury to today's public hearing. I remind you that the evidence that you give at the public hearing today is considered to be part of the proceedings of parliament and accordingly any attempt to mislead the committee is a very serious matter and could amount to contempt. The committee has received your submission No. 13. It has been authorised for publication. Are there any corrections or amendments you would like to make to your submission?

Dr Henry—Mr Chairman, there are no corrections or amendments that we would like to make.

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

Dr Henry—There have been some developments subsequent to our submission. Before going to that—and I will indeed be brief, Mr Chairman— perhaps I could just say a few words which attempt to pick the eyes out of our submission and which I hope go to the terms of reference of the committee.

The key points as we see them are as follows. The main challenge from financial globalisation has not to do with the volume of international capital flows but rather the potential volatility of those flows and, in particular, the risk of a reversal of flows and, associated with that, contagion. Contagion does appear to be a relatively recent feature of financial crises. Globalisation does not appear to have resulted in an increase in financial market volatility in Australia. National economic policies matter.

The recent financial crises have revealed shortcomings in the way that international investors evaluate and price risk. The recent financial problems have drawn attention to the need to improve transparency and disclosure in both the public and the private sector, including by financial market participants such as highly leveraged institutions. They have drawn attention to the importance of developing codes and standards, particularly to strengthen risk management and prudential regulation. They have drawn attention to the risks and vulnerabilities associated with excessive short-term borrowing, particularly short-term borrowing in foreign currencies. They have drawn attention to the need for capital account liberalisation to be undertaken in a manner and at a pace that is consistent with the country's financial infrastructure.

There is a need for improved surveillance and there is a need to look at the official financial rescue packages, including, in our view, the development of a framework to guide private sector involvement in crisis resolution and also, of course, in crisis prevention. Those we would see as being the main points.

Can I bring the committee up to date following the preparation of our submission. Since that time, the socalled G20 has been established. It was established by the G7, agreed to by the G7 leaders in their June 1999 meeting, and it has had its first meeting in December 1999 in Berlin, where finance ministers and central bank governors discussed ways to address the main vulnerabilities facing their respective economies and vulnerabilities in the global financial system.

In the area of transparency they agreed to what are referred to as ROSCs. It is an acronym for reports on observance of standards and codes, something that we had been referring to as transparency reports. Committee members are probably familiar with Australia's transparency report which was presented to the March 1999 meeting of the Manila Framework Group. Ours indeed was among the first four transparency reports produced. They agreed also with need for financial sector stability assessments. Those, I think, were the main outcomes of the first G20 meeting in Berlin.

The Financial Stability Forum was established earlier in 1999. You will recall, I think, that in the middle of 1999 Australia, Hong Kong, Singapore and the Netherlands were invited to join the G7 members who make up the Financial Stability Forum. Work has been continuing in the Financial Stability Forum in three working groups and in a number of other study groups, I suppose you could call them. The working groups have focused on the activities for highly leveraged institutions, capital flows and offshore financial centres, but the other work that is going on in the Financial Stability Forum concerns the implementation of standards relevant to strengthening financial systems and mechanisms to promote the introduction of standards. Australia is a participant in the work on highly leveraged institutions and in the work that is going on in respect of the implementation of standards. That work of the Financial Stability Forum working groups will be considered by the Financial Stability Forum at its meeting later this month.

I will close there, Mr Chairman. We are of course happy to enlarge on any issue that is raised in our submission and, indeed, to address any other issue that the committee might think is relevant to its terms of reference.

CHAIR—Thanks, Dr Henry. If we talk of more recent events, we saw what seemed an unusual occurrence when the Reserve Bank put up official interest rates by half a per cent and the dollar dropped. Would you care to comment on that?

Dr Henry—No, we do not comment publicly on the Reserve Bank's actions in respect of monetary policy, nor do we comment on the exchange rate.

CHAIR—Not on the exchange rate, but the fact is that here we have a situation where one would assume that putting up interest rates should strengthen the Australian dollar and the opposite seems to happen. It would appear from public comments that there was some decision by major capital institutions to withdraw funds from Australia. Maybe looking at it from another angle, you have the fact that the impact on the Australian economy from that is obviously not all that helpful. On the one hand, you have interest rates going up, which will make the cost of borrowing high. On the other hand, you have a weaker dollar which again, while it would certainly help exporters, will not help other parts of the economy.

Dr Henry—I would agree with your observation that, other things being equal, higher domestic interest rates should strengthen the value of the dollar. Clearly there are other factors at play.

Mr Johnston—I think the Governor spoke to the committee about some of these other factors, including positions that were being taken in the United States.

Dr Henry—As to the economic effects of a depreciating currency and whether that is a cause for concern, we would say that the fact of the dollar being allowed to depreciate by some 20 per cent in the aftermath of the Asian crisis was not the only factor but was key to the ability of the Australian economy to withstand what was a fairly adverse external shock. The depreciation of the currency at that time did much to maintain in fact to enhance Australia's competitiveness in what was becoming a relatively weak environment, particularly for exports into our region.

A depreciation on its own we do not regard as being a problem. A depreciation becomes a problem if the currency depreciation feeds into domestic inflation. That would be the issue. These matters though, as I said, are matters for the Reserve Bank to have an eye to and I think that, as my colleague Mr Johnston reminds me, those matters were covered by the Reserve Bank in its evidence to this committee.

Mr LATHAM—I had a few matters I would like to raise. Recently David Hale had published in one of the newspapers here an argument about our currency and its vulnerability. His argument, essentially, was that Australia has had 15 years of economic reform and this has built some good feeling about progress in this country, but internationally we are still seen as a commodity currency and the proportion of Internet stock value on our share market is very low, particularly compared to the United States, and as long as we remain a commodity currency we are always going to be more vulnerable than we would like and, obviously, linked to fluctuations in commodity prices and prospects around the world. Treasury, having driven 15 years of useful economic reform in this country, must be somewhat concerned that this progress domestically has not filtered into international currency markets and that we still bear the burden of our commodity reputation. Is there anything that Treasury could suggest by way of policy change or strategy that might help with this dilemma?

Dr Henry—Let me pick up a couple of points. I should say at the outset that we would not regard a stronger Australian dollar in all circumstances as being a sensible objective of macro policy, so—and I am sure he will correct me if I have this wrong—to the extent that your question implies that a weak dollar is an indicator of policy failure, we certainly would not notice that.

Mr LATHAM—No, unexpected fluctuations, which is what we have had recently.

Dr Henry—Fluctuations in the dollar are important. That is why we have a floating exchange rate, to permit fluctuations in the dollar, to ensure that when there are adverse external shocks or even good news external shocks for the Australian economy, those do not have an overly pronounced impact on the domestic economy in the sense of creating domestic imbalances. We do not see any difficulty in the exchange rate moving.

The second part of your question though is a much more difficult one to deal with—and the more important one—and that is whether, despite 15 years of economic reform, Australia is not still seen as largely a commodity producing economy. I will say a couple of thing to that. I do not believe that that is the case. I think that increasingly Australia is being seen internationally as the sort of economy that we domestically know it is, and that is a pretty dynamic economy, including in its uptake of new information technology and communications technology.

The recent weakness in the dollar, incidentally, has been associated with strengthening commodity prices, not with weakening commodity prices, and with a strengthening in the terms of trade. That suggests that not all movement in the exchange rate can be explained by changes in commodity prices. Over time there does seem to be some correlation between commodity prices and the Australian dollar, but it is certainly not always the case that the Australian dollar moves in the same direction as commodity prices. As I said, commodity prices are strengthening at the moment and have been strengthening for some months— Paul could fill you in on that—as the Australian dollar has been weakening, so presumably there are other factors at play.

You referred to global interest in Internet stocks in the United States, and I guess that is illustrated by the strength of the Nasdaq index. It is certainly the case that global finance is shifting into those areas in the United States, but it does seem to be the United States. That is, it seems to be the United States versus the rest, rather than there being something extraordinary about Australia.

Mr LATHAM—So you are not too concerned about the reputation of the currency and do not really see it as a policymaking question? In David Hale's article the inference was that Australia needs to do something about Telstra and its global positioning as an IT company of the future instead of the singular obsession with its future as a domestic company providing telephone services.

Dr Henry—I would be concerned about the reputation of the Australian dollar if it was producing a value for the dollar that was out of line with our fundamentals, but I do not believe that over time that has been the case. Certainly there have been instances when the dollar may have been appreciating too rapidly or depreciating too rapidly, but those are relatively short-term phenomena, as you would expect in a currency that is floating. Just because they are short-term phenomena does not mean that we should not be concerned about them. Indeed, I think that is one of the issues that is well and truly within the committee's terms of reference—the extent to which one worries about overshooting of the exchange rate, even in a relatively short period of time, and overshooting in either direction. But I am not sure by any means that the international reputation of the Australian dollars causes it over time, over a medium term, to move in a way that is out of line with Australian fundamentals. I do not think that is the case.

Maybe it is the case that a lot of traders in international currencies think of the Australian dollar as being largely commodity driven, as some sort of currency proxy for commodity prices, but I think that financial markets are becoming increasingly sophisticated. I think there is more to it than that, and I think that certainly in the Asian crisis the fact that Australia's economic performance was so resilient owes something to the fact that international financial markets have become increasingly impressed by the policy framework that exists in Australia. One bit of evidence for that is the gap in yields between US 10-year bonds and Australian 10-year bonds. We are not now talking about exchange rates, but I think that is a pretty good indicator of the acceptance by the international community of the sophistication of the economic policy framework in Australia.

Mr LATHAM—Are there things that international financial markets might be worried about—our chronic current account deficit, stubbornly poor national savings? Are there other policy issues away from direct questions on the currency that need to be addressed?

Dr Henry—There is no evidence to date that international financial markets are concerned with the size of Australia's current account deficit in a structural sense. Certainly the current account deficit has expanded cyclically, as Australia has had very high rates of growth relative to the rest of the world, and particularly relative to our export markets. The current account deficit has certainly expanded in the last couple of years. That, I think, is by and large seen by international financial markets as being cyclical and something which will come back down as far as the current account deficit is concerned, and we believe that the current account deficit is beginning to narrow. Export performance has been very strong recently and there are indications that that will continue to be reasonably strong.

Notwithstanding that, Australia does have an imbalance between domestic saving and domestic investment and that, of course, is reflected in a reasonably high underlying or ongoing current account deficit. Yet it does seem to be a current account deficit or a savings-investment imbalance which is quite acceptable to international financial markets. They are quite prepared, it seems, to fund a domestic savings investment gap of three to four per cent of GDP even when cyclical conditions are favourable to the current account deficit. That suggests that as far as the international community is concerned, there are good opportunities in Australia for investment, and I think in all forms of investment: lending, but also both portfolio and direct equity investments.

Were that not the case, I think we would be facing significantly higher interest rates on our borrowings than we are facing. As I noted, the yield gap on 10-year bonds between us and the United States is less than one-half of one percentage point or 50 basis points, and I can certainly remember at earlier periods in the 15-year period that you referred to when we would have expected the yield gap year-on-year to be in the order of 250 to 260 basis points.

As you would be aware, in the 1980s there were a few periods when it was pretty clear that the international financial markets got a bit concerned about the size of the current account deficit. I think they have learnt a lot. I think they have become more sophisticated in their appreciation of the underlying strength of the Australian economy and the strength of our policy frameworks, and I think, as I said earlier, that has a lot to do with the narrowing in that yield gap.

Mr LATHAM—The former Treasurer, Ralph Willis, used to tell Labor Party meetings when we were in government that the golden rule—and I assume this is acting on the best advice of Treasury—was that if the Australian current account deficit got out towards six per cent of GDP, that is the trigger point at which markets might become somewhat nervous about our position and perhaps run on our currency. Is there still a trigger point, a golden rule, in place in the eyes of Treasury or has that sort of thinking become somewhat redundant?

Dr Henry—We do not have any particular trigger point in our minds when we assess the size of the current account deficit. The issue for us, and it is very difficult to quantify, is whether the current account deficit is sustainable. That is a rather difficult thing to quantify, although there are various indicators around. One can look at the rate of accumulation of foreign debt and of net foreign liabilities or net foreign currency denominated liabilities. On both of those indicators, Australia looks fairly good. At the moment the rate of accumulation of foreign debt is slowing appreciably; it has flattened out as a proportion of GDP, and we do not have net foreign currency liabilities. We have net foreign currency assets, and we have had for, I think, the last four or five years. So those indicators of vulnerability with respect to the current account deficit look pretty good, and those indicators are probably of more use in judging the sustainability of the current account deficit than any magical ratio of the current account deficit to GDP.

What makes it incredibly difficult is stripping out cyclical elements from structural elements. It is obviously the case, given what has happened to Australia over the last couple of years, that cyclically we can run a current account deficit at six percentage points of GDP, because we have, without there being an adverse international market reaction. Cyclically, that does not seem to be a problem. On a structural basis, of course, one would be much more cautious about making any such statement.

CHAIR—Dr Henry, I want to come back to some points that Mr Latham raised earlier. You mentioned that financial markets are becoming increasingly sophisticated. You talk about placing of capital right now. We have seen some extraordinary phenomena through the stock market. In Hong Kong now, the tom.com, blue sky, oversubscribed 700 per cent, and it hit the market at about five times its issue price; the son of the promoter of that buys the Hong Kong telephone company and has a capitalisation greater than General Motors now. Without wishing to comment on his ability or otherwise, Berkshire Hathaway, Warren Buffett's outfit, is reported today as having its worst year ever because it stuck to what you might call the traditional investments and has not gone after some of these new things. Is there some imbalance building up here that because the flavour of the month is to go after anything that has 'dotcom' after it? When you say 'increasingly sophisticated', isn't there a concern that this imbalance is becoming a bit like past booms that end up causing more problems and maybe on a bigger scale than we have experienced in the past?

Dr Henry—Indeed, it may well be. There does seem to be a fair amount of exuberance, whether it is rational or irrational, in relation to socalled dotcom stocks. When you say that traditional industries even doing quite well are having a hard time of it, certainly the stock prices of so-called traditional industries have not performed anything like the stock prices of high tech companies, despite the fact that a lot of traditional companies are experiencing, historically, very high profitability. The shareholders of those companies are benefiting through higher dividends. That is happening, but it is not being reflected in higher stock prices, and indeed there is probably something in your suggestion that investors are looking increasingly to the new IT industries, new IT companies.

I would not want to give the impression by any means that stock markets, like currency markets, will not overshoot from time to time. I think everybody accepts these days that they will. The question for us is: if such markets do overshoot and if there is a correction in such markets, as inevitably there is, will that correction have adverse consequences particularly for Australia? That is the question that we are interested in. You could put it in the following terms: if there is a sharp correction in the United States in the US stock market, would that sharp correction have adverse consequences for Australia's macroeconomic performance? That is the sharpest way I think you could put the question. It is obviously something that we look at.

We do not believe that the issue is clear-cut by any means. It may well be that such a correction would be associated with a shift in global funds out of the United States into places like Australia. It may well be, therefore, that that could be a positive capital market driven stimulus to the Australian economy. It is really the issue of the consequences of a correction that we would be most concerned with. I am not disagreeing with your proposition at all that there may be some overshooting going on in US IT stocks.

CHAIR—That comes back to your opening remarks. You were saying that the problem is not volume but volatility of capital markets.

Dr Henry—Yes.

CHAIR—If that increases the volatility, aren't there some adverse effects for imports and exports in Australia?

Dr Henry—Provided the domestic economy is sufficiently flexible to adapt, including through prices—and the major price, of course, would be the exchange rate—and without an exchange rate adjustment having ongoing effects on inflation or even deflation in Australia, then I think we can be, if not sanguine, at least reasonably comfortable that we can weather such vulnerability. There have been instances of extreme volatility just in the last couple of years, as you know, in connection with the Asian crisis that Australia has weathered remarkably well. That does not mean that volatility is not an issue. Of course, volatility is an issue, but the element of volatility that we need to worry about—and it is the one that we worry about—is: what are the consequences of a market correction? As I said earlier, that is what we have been focusing on and we will continue to focus on.

The other element that we got more than a little concerned about in the Asian crisis was volatility that was perhaps being driven by a small number of market players who may have seen some advantage for themselves in engineering volatility. This goes to the issue of market manipulation. Market manipulation would certainly be something that concerns us, and that is why in the context of the debate on the international financial architecture we have, among other things, called for greater transparency in respect of the operations of all market players, both public sector and private sector market participants.

I do not think that those issues are particularly relevant to what we are seeing happen to IT stocks in the United States. I think that is something else. That is, if anything, over-exuberance on the part of millions, perhaps even billions, of investors.

CHAIR—You obviously still see this question of manipulation as a potential problem.

Dr Henry—We see that as a potential problem.

CHAIR—What do we do about it?

Dr Henry—As I said, we have been pressing for greater transparency—that is, for example, highly leveraged institutions provide more information of higher quality on a more timely basis to their counterparties, but also just publicly. So that those who are responsible for regulation of markets have more information about the positions that are being taken by particular market participants. It is something we have been calling for and there has been substantial progress in that direction. As I said, work on highly leveraged institutions by the Financial Stability Forum Working Group will be considered by that forum later this month and we expect further progress there as well.

CHAIR—How satisfied are you with the progress to date, or do you want to take that on notice and give us an answer in a month's time?

Dr Henry—If you would like a reassessment in a month's time, we would be happy to do that, but we have been very pleased with the progress on this issue. Certainly in the United States, which is, as you would guess, where it matters most—that is, where attitudes to this issue matter most—we have sensed a developing attitude in favour of greater disclosure—certainly to counterparties but, beyond that, greater public disclosure of the positions that are adopted by highly leveraged institutions, hedge funds and so on in respect of currency trading in particular.

Mrs HULL—Recently we have seen the possibility of mergers between the Commonwealth Bank and Colonial Ltd. The global nature of the financial services industry was emphasised during these discussions, although there has been some change in those, I recognise. There are those that appear to be very sensitive and nervous about the term ‘globalisation’. In your opinion, does globalisation reduce the government's scope for independent policymaking?

Dr Henry—No, it does not. Globalisation is something that has been with us for a long time. In fact, as our submission notes, if one looks at trade flows and even net capital flows, the globalisation that we are experiencing today is not that much different from that that was experienced toward the end of the 19th century and the early part of the 20th century. Certainly in terms of gross capital flows things are rather different. There is certainly a higher volume of capital flows, but in terms of net capital flows and in terms of trade flows the sort of global integration that we have today does not appear to be much different from that of the early part of the 20th century and the latter part of the 19th century.

I think what is significantly different is that today we have much more readily accessible and much cheaper information technology, telecommunications and so on. It means that information is distributed much more quickly and much more comprehensively than it ever was and it means that transactions can be undertaken in very short spaces of time. Governments have been, therefore, dealing with globalisation for a very long time. Indeed, whilst I went back to the last 19th century, there have been elements of globalisation in the policy considerations of governments for thousands of years, if by ‘globalisation’ we mean greater integration between one group of people and another group of people. Your question is: does that mean that domestic governments or national governments have less power to set national economic policy?

The evidence is that it does not mean that. National governments are every bit as activist in setting national policies now as they ever were, perhaps even more so. It does mean that national governments will have an eye and should have an eye to international perceptions of their policies. But our view would be that it would be hard to run an argument—certainly in Australia's case—that what is seen to be good by international investors is not good for Australia. People will run that argument but, to my mind, not at all convincingly.

Basically, what international investors tell us is that when they look at Australia, what they want to see is an economy with strong and sustainable growth, growth that does not give rise to inflationary pressures and does not give rise to unsustainable positions with respect to the current account deficit and, when we think about what is good for Australia in terms of its macroeconomic performance, we would say much the same thing. Governments have to pay attention to the views of international financial markets. That is certainly true and there is, therefore, a discipline that is placed on governments through the operation of international financial markets. It is difficult, however, to run an argument that there is something wrong with that discipline.

Mr WILTON—Getting back to the issue of hedge funds and their role in influencing the markets, there are some who would suggest that having a debate here towards the regulation of hedge funds would be a good thing. Do you have any view on whether or not hedge funds in broad terms should be regulated?

Dr Henry—Our view on this is that much would be gained, and perhaps everything you need would be gained, by greater information disclosure. The qualification to that is that it may be that it would be possible to have hedge funds sign up to a voluntary code of practice in relation to their activities, and we certainly would not stand in the way of that. It may indeed be in the interests of hedge funds as a group. They have a rather tarnished reputation, I would have thought. It may be in their interests as a group to develop and to sign up to a voluntary code of practice. We see in all sorts of industries, including in quite a number of domestic industries, where the market participants find it in their interests to, in a sense, regulate themselves. We would not stand in the way of that.

Mr Johnston—Could I add to that that, one step removed, we are heading in the direction of greater supervision of hedge funds through regulation of the banks that act as counterparties to the hedge funds. This is the very encouraging story that is coming out of the United States: that the onus on the banking sector, who act as counterparties to the hedge funds, will be to provide much better reporting and also to look much more closely at the credit risk and adequate provisioning, reflecting their exposures to highly leveraged institutions.

Ms BURKE—To summarise, it is almost impossible for Australia on its own to actually do much more across a global set of regulations. We need some sort of bigger type of environment that we are probably not going to get everybody to sign up to. Bearing that in mind, how then do we regulate, or where do we go to ensure that some of this regulation can happen that everybody is going to sign up to, where each economy is going to say, ‘Yes, we'd like to tick on to being regulated this way’?

Dr Henry—I might ask Ms Spindler to add to my remarks, but let me give you a bit of a sketch of it. There are a number of international forums today in which these issues are being discussed: obviously in the international financial institutions, principally in the International Monetary Fund; in the Basle Committee on Banking Supervision; in the Financial Stability Forum, which is, as I indicated earlier, the G7 plus Australia, Singapore, Hong Kong and the Netherlands; in the recently formed G20, which again includes Australia; in the Manila Framework Group; in APEC, and so on. These issues are on the table. Those are by definition multilateral fora which provide a place for domestic regulators, domestic policymakers, to get together and to discuss forms of regulation which may be appropriate in this industry.

Most of the work that has been done, or most of the progress, has been in respect of the development of codes and standards of best practice and, added to that, transparency. Transparency goes to the extent to which countries' national jurisdictions indicate publicly the extent to which they satisfy or sign up to or observe relevant codes and standards, and associated with that—and this is really the third leg of it—regular surveillance of countries' performance in those codes and standards.

Ms BURKE—Who would perform that role?

Dr Henry—The International Monetary Fund is the most obvious place. Indeed, they are doing that, and increasingly doing that, through these ROSCs that I referred to earlier, reports on observance of standards and codes. Australia's transparency report, which was produced in March of last year, has been considered by the International Monetary Fund. Ours was a self-assessment report. I think it remains the only self-assessment report, does it not?

Ms Spindler—I think the only one that is entirely self-assessment.

Dr Henry—Yes. The International Monetary Fund staff have conducted transparency reports, these days called ROSCs, in respect of a number of other countries, including for example the United Kingdom. That is going to increase substantially and it may well be in fact, it is highly likely that as a regular part of article #IV reports, which the IMF conducts on all of its 182 members, a part of the report will deal with the country's observance of internationally accepted codes and standards in, as I said, a whole range of areas, including banking supervision. That is the way I see it progressing. Again, it is just greater transparency about what countries do, but I think it is a transparency that is becoming increasingly valued by individual countries. It is being valued because the international financial community is wanting this information and it is increasingly being seen as being in countries' own interests to provide the information. Is there anything you want to add to that, Karen?

Ms Spindler—The only thing I would add is that a lot of the issues that are being dealt with and that you raise in your question are the responsibility of domestic governments. It therefore needs to be a voluntary process. As you indicated, countries need to be willing to sign up to regulation or to observance of standards, and we would not want it any other way I do not think. We would not want to be required to meet a particular set of standards set by an international body. It is a matter of trying to show countries what the benefits are to them of signing up to standards or codes and it is therefore something that has to hasten slowly through a number of international fora and, in particular, the ones that Dr Henry outlined.

The IMF is the most logical place through which implementation will occur, not least because of its very broad membership, but it has a number of disadvantages. It can get a bit bogged down in process sometimes, and it has a limited role. It has a reasonably welldefined role. It does not necessarily cover all the areas of an economy that these issues arise in. Those are some of the reasons behind the formation of the G20, which is providing a very highlevel body within which these sorts of issues can be discussed and can be discussed in an informal way by ministers. It is another route through which action can be encouraged and it is a matter of drawing together the threads that come out of a variety of fora that will include APEC and Manila Framework Group and a host of others.

Ms BURKE—Is Australia active enough in these sorts of areas? Are we on enough of these wonderful committees? Do we have enough representation? Are we playing our part?

Dr Henry—I think we are. In fact, I think this has been one of the success stories of the last couple of years. I think it is quite extraordinary that Australia is represented on the Financial Stability Forum. As I said, the Financial Stability Forum was established by the G7 for the G7 basically, and Australia, along with three other economies, was asked to join the Financial Stability Forum. I think that is testimony to the input that we have had into the debate, but also it is a recognition that Australia itself is of some systemic importance in the global financial system, as is Hong Kong, as is Singapore and as is the Netherlands.

We are on the Financial Stability Forum. We are a member of the G20, which, as Ms Spindler said, is the ministerial forum that will increasingly be taking these issues forward outside of the International Monetary Fund. Obviously we are an influential player in what goes on in the International Monetary Fund. In anybody that I talk to, there is no sense of frustration at Australia's exclusion from any of these forums. I think we can be well pleased with the involvement that we are having.

Ms BURKE—It is a bit like driving a car, though. You know what you are up to. It is those on the road around you that you worry about. So although Australia is probably one of the best insofar as prudential regulations are concerned, and that has obviously helped us in the recent Asian financial crisis, it is those around us that I suppose—

Dr Henry—Yes.

Ms BURKE—How do you regulate those? How do you say to the recalcitrants—coining a phrase—‘You're the ones that we actually want to come into line’? That is our greatest problem, isn't it?

Dr Henry—Sure. As Ms Spindler said, there is no point trying to do it other than through a voluntary process. I have to be a little cautious in saying this, but the evidence to date is that, including in our region, more and more economies are seeing value in greater transparency, in stronger domestic regulation in respect of particularly corporate governance issues, prudential regulation in the financial system, insolvency and bankruptcy proceedings, strengthening the judicial system and so on. All of those good governance issues are becoming increasingly important to economies, including in our region. It will be, hopefully, the lasting testament of the Asian financial crisis.

When Asia went into crisis, or a great part of Asia went into a crisis, it was not because they had inappropriate macroeconomic policies. By and large, they had very strong macroeconomic policies. It was because they lacked the sort of market infrastructure that was more a hallmark of places like Australia than of Asia. In fact, I remember in the 1980s we used to be compared very unfavourably with the Asian tigers and, if you went to the base of those criticisms, it was really that we were too pure. Well, I think increasingly the Asian economies are becoming more pure.

Mr LATHAM—Following up on that point, your submission is a little critical of the IMF and its lack of surveillance in picking up potential problems in Asia. Is the IMF improving its surveillance mechanisms as Treasury would like?

Dr Henry—Yes. I think the IMF itself would say that it learnt a number of lessons out of its involvement in the Asian crisis. One is that it did not have a sufficient number of, or sufficiently sophisticated, early warning signals in its own work, in its own surveillance activity. We have been—that is, Australia has been—a key player in setting up supplementary surveillance mechanisms, including the Manila Framework Group, which was established in the context of the Asian crisis, primarily because we saw a need to enhance surveillance of regional economies' performance, and in other ways as well we have been pushing for enhanced surveillance.

The Financial Stability Forum, of course, concerns itself principally with surveillance. What it is looking at is vulnerabilities of economies to financial crises, and particularly financial crises which might have some sort of systemic impact on the global financial systems, so it is concerned as well. But, yes, I think that the International Monetary Fund has done quite a lot to improve surveillance mechanisms. I am not saying that it has necessarily gone far enough, but I think quite a lot has been done. I think a lesson was learned.

Mr LATHAM—How do these two new initiatives, the supplementary reserve and the contingent credit line, work?

Dr Henry—Let me talk about the contingent credit line. Maybe somebody else can talk about the supplementary reserve facility. The contingent credit line was designed to deal with what was perceived as being a relatively new phenomenon. Financial crises and currency crises are something that have been with us for a long time. What appeared to a new element in the Asian currency and financial crisis was contagion. That was a concern for Australia, that what was happening to the north of us would impact on us in financial and currency terms. It did not happen, but we did see echoes—and maybe they were more than that—in Latin America and also in Russia.

What countries have been concerned about—and I think it is fair to say the United States in particular has been concerned with—is that the International Monetary Fund has in place an instrument which can be activated very quickly in times of crisis to prevent contagion. That is why the contingent credit line has been developed. It is contingent in the sense, however, that there are pretty strict prequalifying conditions on countries. There is certainly no sense in which IMF members would automatically qualify for the contingent credit line. They would have to have in place a set of reasonably well-prescribed policies, frameworks, before they qualified.

I do not know if that is why, but nevertheless it is the case that the contingent credit line has never been used. Will it be used? I do not know. I think it is too early to say. There is certainly a lot of commentary around the place to the effect that the contingent credit line is simply too restrictive. In fact, I think some would go so far as to say that if a country satisfied all of the conditions that are necessary to qualify for the contingent credit line, then it would never need it, and that may be the case as well. I think that there is a sense in which the development of this instrument is intended to have countries go further down the line of the adoption of appropriate regulatory arrangements and so on.

That is what the contingent credit line is about. It has not been used. It may be used, but the conditionality is such that I think it is probably unlikely to be used by a country that would really satisfy the various elements of conditionality attached to it.

Mr Johnston—The supplementary reserve facility is a fairly new facility as well. It was used in the case of Korea. The aim of the supplementary reserve facility in terms of going along a continuum of fund facilities was to provide a facility where you could marshal very substantial financial support, but it is provided on a short-term basis and at a fairly high cost. In the case of Korea it seemed to work pretty well, but at the moment there is a debate going on about the range and character of fund facilities. This is something that will be discussed over the next year or so in the IMF board—just where the weight of fund financing should be located on this spectrum and the sorts of products that should be offered.

Mr LATHAM—Is there a problem with the organisational structure of the IMF? A body that I have had contact with, OECD, always strikes me as a just so heavily bureaucratised, slowmoving, creaking organisation that it ends up with the policies of the lowest common denominator—what pleases a big and diverse membership. Is the IMF like that, and is that a huge structural problem in that these markets move quickly but, if you have some groaning, creaking, multilateral group that moves with the pace of a snail, it will always be caught out and always be several steps behind the mark?

Dr Henry—That is clearly the risk, but I think the important thing is that everybody knows that that is the risk. Everybody understands that when you set up a large global institution like the IMF, even more so than the OECD, the risk is that it will proceed at a snail's pace, and particularly if it relies on consensus. The IMF does not actually rely on consensus—at least, formally it does not rely on consensus. It differs from the OECD in that sense. The OECD does, and it has been said of the OECD—usually unfairly, but you can understand why the comment is made—that the OECD on a contentious issue is going to produce the lower common denominator result. I think it is a little unfair, because the OECD, on even contentious issues, has over time produced even controversial—let us call them brave—policy prescriptions.

The IMF is slow to act because programs need the approval of the board, but when the IMF starts work on a country in crisis it is reasonably quick to throw staff resources on to the issue. It is reasonably quick to get a dialogue going with the government, and with other interested governments even. There can be delays, certainly, in getting issues to the board, and I am not sure, but this may be what is behind the Meltzer commission recommendation. The Meltzer commission brought out its report late last week, with a recommendation that essentially the process of negotiation between the fund and a country not exist; that we do not have a process of negotiation; we simply have short-term emergency, essentially lender-of-last-resort, financing which is available to a country, provided that country meets particular conditions. The country has to prequalify by meeting a range of conditions but, provided it meets those conditions, then the funding is provided automatically.

It may be that it is this sense of timeliness or the need for timeliness that is behind that recommendation—I am not sure—but when I read the report I wondered if that was not what could explain it. I am sure there are occasions on which the IMF processes can be a little too slow for what is needed in the specific circumstances of a country, but it is not at all clear to me what the alternative is. Basically, these are quasishareholder funds that are being used by the International Monetary Fund. All members of the fund have a valid interest in having an input into the way in which those funds should be used.

The other thing I would say is that there is substantial evidence that the IMF is getting better at what it does. The IMF has dealt with crises for a long period of time, but I think what has happened in the last couple of years has caused the IMF to look at the way in which it does its work.

Mr Johnston—Could I add a couple of points to that. In the Asian crisis there was a lot of criticism of the fund for going in too hard and being too inflexible, but I think if we reflect on the programs and how they have evolved in the region, we have seen the fund make quite substantial changes to program parameters and, in particular, easing the fiscal conditionality and the budget targets for countries in the region. So it has shown on-the-ground flexibility and accommodation. The other point that senior staff at the fund would make—and they are pretty sophisticated people and dealing at very high political levels—is that it is very important to the success of a program in a crisis country that there is ownership by national authorities, and this is something that takes a bit of time sometimes. But where we have seen programs go well—for example, again, in Korea—there is a very strong national ownership of the program.

Mr LATHAM—On the particular case of Indonesia, where it does not look like things went all that well, with the benefit of hindsight what should the IMF have done differently? Should it have been more insistent on political reform and improvement in institutions of civil society and, in particular, decent financial standards and structures? What can be learnt from that experience?

Dr Henry—I think the Indonesian program is still seen, even today, as being a very ambitious program in respect of those structural issues, governance issues. It is seen as being very ambitious.

Mr LATHAM—Is this the threshold question of why didn't the IMF insist on the military being phased out of civilian governance? There just seemed to be a basic question of what makes a country work properly and what gives it some respectability in international financial circles. It just seems that there was very little done on those fronts in Indonesia and, for all the money that was going into the country, some of it Australian money, it seemed to be allowing an extended period of political paralysis to unfold.

Dr Henry—Others no doubt will have something to add to this—perhaps Terry—but I think that an institution like the International Monetary Fund is put in a rather difficult position. When you have a crisis of the dimensions that affected Indonesia, basically you have people starving—it was that bad. There is seen to be a need for the IMF to act in terms of provision of financial assistance. There are not many people who would be backing the IMF in those circumstances and saying, 'Well, don't go in until they have done this, this and this,' including for example getting the military out of the political system.

That is the situation that the organisation is in. There is a pressing need to be seen to be dealing as a matter of urgency with the humanitarian side of the crisis but, at the same time, by the time the crisis is over the IMF obviously wants to achieve a set of policies and institutional frameworks which are superior to what was in the country before the crisis erupted. That goes to a whole range of issues, including social and political infrastructures. It seeks to do that by the exercise of conditionality in its fund programs, so it says, 'You want this money; that's fine, but you have to agree to do the following things.' Usually it will be reasonably ambitious.

I think in the case of Indonesia most observers and most commentators would say that the IMF is still being very ambitious. I think what they mean by that is that they think the IMF is being too ambitious. What they say is, 'The IMF is being very ambitious,' and our sense is that the IMF is being appropriately ambitious in Indonesia. Could they go further? It is a hard judgment to make. It is a judgment that the IMF itself has to make and the executive board seeks to make that judgment when it considers the program, but I do not think these things are clear-cut by any means.

CHAIR—Dr Henry, I want to come back to the sentiments that Mrs Hull brought up. We talk about the capital markets and the influence they are having, but some of the players are getting bigger and bigger and, let's face it, some of them are getting very large. I do not know how big Deutsche Bank is but it is something extraordinary. I am not suggesting they have any ulterior motives, but it does reach a point where these big corporations are in a position to intimidate governments and will often be pushing governments to make decisions which would be in the interests of the corporation rather than necessarily in the interests of the particular country. At what stage do we say this is of concern and what is the sort of response we should have to that possibility?

Dr Henry—We probably need to discuss the premise of your question more first. Is it the case that large market players are intimidating sovereign governments and requiring that sovereign governments do things that they do not want to do? Or perhaps more particularly, are they requiring sovereign governments to do things which are not in the best interests of their citizens? I think that is the premise of your question. Is it valid? I would not want to rule it out, but I cannot think of much evidence to that effect. There may be cases where large market players seek to manipulate market outcomes. I can accept that, but are they in some sense dictating to sovereign governments what sovereign governments should do?

CHAIR—They may not dictate, but you say, 'What evidence?' I suppose you could look—

Ms BURKE— We could look at Microsoft.

CHAIR—An example—going back some years now, of course—was the auto players in America buying up the trams of Los Angeles, removing the trams and, arguably, Los Angeles suffers from much worse pollution because one form of public transport was removed in the interests of market players, not in the interests necessarily of the community.

Dr Henry—That goes to a much bigger issue. I think we would analyse it in terms of whether government regulation requires or is sufficiently strong to require that market participants pay all of the costs of their market activity, including externalities. For example, in the case that you refer to, it is pretty clear that General Motors is not paying for whatever additional element of air pollution there is in Los Angeles that could be attributed to what it is that General Motors did. That is a big question. That sort of question is something which is within the competence of national governments to do something about.

They can require that large multinationals actually pay for all of the costs, including those external costs, those negative externalities, of their market activities. The question is: do they? Too often, one might say, they see it as being in their own interests, national interests or political interests not to require large market participants to pay the costs of the externalities that those market participants produce. That is more often the case, I think. It is not the case that a government gets bullied by a large player in the market but, rather, that the government, for whatever reason, decides that it is not going to require that market player to pay for all of its costs.

Mr ALBANESE—One of the things that stops the externalities being paid for in an appropriate fashion is the mobility of capital. You have a bidding war, effectively—a public subsidy bidding war—which occurs quite regularly here in Australia, and between state governments unfortunately in Australia as well, in terms of bidding to get that capital investment in a particular geographical place.

Dr Henry—Sure, that is the case. The question is whether governments should be engaging in that sort of activity. That sort of activity characterised East Asia precrisis.

Mr LATHAM—It's a mug's game.

Dr Henry—I hope I will not reveal the name of any particular company, but I remember a very large global player talking to me once about oil exploration activity in Australia, and the reason that they were not involved was our tax regime, the petroleum resource rent tax. They said, 'We go into the Gulf of Mexico. There's no secondary taxation. If you want us to invest in Australia, you're going to have to drop your secondary taxation.' The proposition was that the owners of the resources in the Gulf of Mexico—taxpayers—were prepared to give away for nothing that natural resource which belongs to them and that, therefore, Australian taxpayers should be prepared to give away their natural resources for nothing. That argument makes no sense to me whatsoever.

CHAIR—I suppose it is a bit of a long bow, but with globalisation and the size of these corporations getting so large now, countries are going to be faced with those sorts of choices all the time. They are not going to be there for altruistic reasons. The pressure is going to be on there.

Dr Henry—Yes, but I do not accept that national governments cannot influence the way in which global players impact on their markets and I do not accept that national governments do not have a choice but to say to some of these large players, 'Oh, well, you can come in and have our resources for nothing,' or, 'We're not going to require that you make your contribution to pollution abatement,' or other elements of congestion or whatever. I do not accept that. By and large, and certainly relative to other economies in our part of the world, Australia has required that companies which invest here are good corporate citizens. By and large we have required that, and by and large we have done pretty well relative to our neighbours.

Ms BURKE—But how do you regulate something like Microsoft? I get the impression from the United States that they are trying; they are taking them to court currently. But we talk about opening up markets, bringing in competition, and this is a direct example of globalisation which has done the exact opposite. One player is dominating the market in an area where you yourself have said that we need to expand—that is, information technology.

Dr Henry—Microsoft has dominated the market because it has been able to do it by substantially cutting prices in real terms. That is the only way it has been able to do it. I was going to say it has not forced its product down anybody's throat, but I do not know whether you would all agree with that.

Ms BURKE—Probably not me, actually!

Dr Henry—But I think, by and large, it has been able to get away with its increasing share of the market because of price and the quality of product. If consumers do not want it, they are not going to buy it. I think it is the case that there is increasing concentration in that industry. It does not necessarily mean that the industry is less competitive in the sense of producing higher prices and lower output to the disadvantage of consumers. Those are the features of anticompetitive practice that we worry about—that consumers are going to lose out because of increases in prices. That is not a characteristic of IT. As I said, it is actually lower prices and improvements in quality of product which largely explain Microsoft's increasing presence in the market. There is presumably a lot more to it than that but, in terms of the most important explanators of its performance, I think it is those things. Faced with that, is there a need for the Australian government to be concerned about the fact that so many Australians are buying Microsoft product? I cannot see what there is in it that Australian governments should be getting concerned about.

Mrs HULL—You indicate in your submission that globalisation does place a significant cost on some sectors of society.

Dr Henry—Yes.

Mrs HULL—Can you explain what sectors of society and exactly how that happens?

Dr Henry—Sure. There are economic aspects of globalisation and then there are social and cultural and even political aspects to globalisation. If you think of globalisation as being international integration, citizens of one country or economy integrating increasingly with citizens of another, from an economic perspective what is going on is that there is increasing specialisation on a global scale. Some of this might be set out in our submission, or perhaps it is only referred to. But start with an essentially subsistence village economy which is cut off from the rest of the world by external barriers. Everything that is consumed by the people who live in that village has to be produced by the people who live in that village. It is no surprise that subsistence economies like that have very low standards of living and it is no surprise that they have very long work hours. If you live in a small village and you yourself have to make everything that you consume, you are going to spend most of your life working, and even at the end of the day you are going to have a pretty low standard of living.

What breaks economies out of that situation is the ability to trade. What characterises trade is that a village like that will sense that if they devoted more of their resources to the production of something they are good at, they would be able to produce sufficient of it to buy from the next village something that that village is good at and which this village is not particularly good at. That is just what economists refer to as the gains from trade.

Countries typically have free trade within their borders. The reason they have that is that they accept that it does not make much sense to say that region A cannot trade with region B. They recognise that if there is free trade, both regions can benefit. On a global scale it is also, in general, in the interests of country A to trade with country B, and it is also in the interests of country B that that trade occurs. Through that same process of exchange, of countries then tending to specialise in the things that they are pretty good at producing, both countries, and therefore the world as a whole, can gain from trade.

So far I have confined my remarks to trade in goods and services but the same argument can apply with respect to movements of capital. The argument there is that the subsistence village that I was talking about could well be a very good site for the location of new investment. It may be that everybody in that village would be much better off if there was new investment into that village, exploiting its own advantages, and it may be to the benefit of the person who has the money to invest in that village that they do it as well, because the rate of return there is higher than the rate of return in that person's village.

So, too, on a global scale. The reason that Australia is able to run the sort of current account deficit that it runs—that is, the reason that we are able to have such a gap between our domestic saving and our domestic investment—is that people in other parts of the world look at Australia and say, 'I'm better off investing in Australia than I am in investing here,' or, 'I'm better off investing in Australia than I am in investing in the United States or investing in Europe or investing in East Asia.' That is another phenomenon of globalisation but, in most cases, that investment is going to be motivated by the fact that the person making the investment can see that they are going to get a higher rate of return and, in most cases, the fact of that investment will be to the benefit of the country that receives the investment. I say 'in most cases' because we have just had an interesting discussion—at least, it was interesting for me—about circumstances in which the investment can actually have external effects which make people worse off.

You asked about people losing and people gaining from structural change. If you go back to the village, if the village is producing everything, everybody is employed pretty much. If the village decides, 'We're now going to specialise in something and we're now going to import shoes,' for example, then the cobbler is out of business. This phenomenon has been happening for millions of years.

Mr LATHAM—Thousands, not millions.

Dr Henry—Not millions, no. Tens of thousands anyway; hundreds of thousands.

Mr LATHAM—Dinosaurs weren't into comparative trading!

Dr Henry—Anyway, a long time. It has been happening for a long time, tens of thousands of years, perhaps hundreds.

Ms GAMBARO—Dr Henry and associates, I am sorry I missed your opening remarks and if I ask you anything that you have covered. I have just arrived. I want to talk about the private sector. I notice that in your submission you have a discussion of private sector involvement in financial crises. There seem to be, from my observations, two types of multinationals: the ones that exit very quickly in times of crisis and then the market predators who come in and try and buy industries that are being devalued by it. Is there some way that the private sector can be used to a country's advantage? I notice that in your submission you dealt with the G7 set of principles that sets out obligations of countries to meet debts, et cetera, and it dealt with the private sector. Can you expand on how the private sector can help a country in financial crisis, if there is such a thing?

Dr Henry—There may be. It is arguable no, in fact I think it is accepted that in the case of Korea it was the involvement of the private sector banks in the bailout of Korea that led to its ability to recover so quickly, so there is certainly something in it. This is a theme that Australia has been pushing pretty hard on since the financial crisis commenced: the issue that private sector investors, including mainly private sector creditors, should be involved in the resolution of crises.

It is often noted that the reason why so many investors went into Asia precrisis was that the rates of return there were very high. Why were the rates of return very high? Part of it was because there were presumably good investment opportunities there, but a large part of it was due to the fact that there was a risk premium on funds that were lent to Asia. The extraordinary thing seems to be that everybody is happy to get the return that is implicit in that risk premium, but they never actually want to bear the risk. So a lot of the funding that went into Asia was very short-term funding—highly mobile capital, therefore. There was a large amount of interbank lending, which is about as short term as you can get and about as mobile as you can get. It is very difficult, when a crisis hits, to require or to force those private sector creditors to get involved in the process of crisis resolution—for a number of reasons—but, typically, you are only going to find out about the crisis once most of them have left or once a large proportion of them have left, and then what do you do?

We have suggested that even in those cases it could be useful, in certain circumstances, to invoke what we would refer to as standstills or standfasts, similar to the provisions that you will find in domestic bankruptcy or insolvency proceedings where somebody with authority blows the whistle, locks the door and says, 'We're all going to sit down and work our way through this.'

Ms GAMBARO—Who would that person in authority be?

Dr Henry—Precisely; that is the question. It is the case that there is no consensus in international circles on that issue. Could it be the IMF? There is no consensus that it should be the IMF. The IMF is looking at the issue. In fact, it is looking at the general question of private sector involvement in crisis resolution. I have spoken about the most extreme version of it, which relates to short-term credit, particularly interbank credit, and, as I said, the IMF is looking at it. In this extreme case there are things like creditor-debtor councils which could be established. There are things like collective action clauses that might be written into bond contracts, particularly sovereign bond contracts where you have a government issuing externally, and it might seek to write into the contract that if certain events occur, some party will represent the creditors, or some group of parties will represent the creditors—some form of collective action clause. There has not been a lot of progress on that front, although I understand —I do not have this confirmed—that the UK government might have recently written such a bond contract. As I said, I need to get that confirmed. Those sorts of things would have been of use to at least one of the crisis affected economies.

There is a whole range of other instruments that are being looked at—contingent credit lines and so on. I think it is fair to say that this is the area in the debate in which least progress has been made to date, but progress has been made and the issue is firmly on the agenda of the International Monetary Fund. I think it is the case that they are going to have to take the leadership on this issue, and they recognise that.

Ms GAMBARO—You were speaking a few moments ago about it being too late if companies start to pull out and then you realise that something is happening. Is there some way of predicting before they start moving out? Is there some mechanism in place that can stop that from occurring, or is it just a market reaction and there is not much anyone can really do about it?

Dr Henry—The answer is we do not know, but nobody is taking the view that this is just a market phenomenon that we cannot do anything about. Nobody is taking that view. That is why in the International Monetary Fund and in other forums a lot of attention is being given to surveillance of the vulnerabilities of particular economies. The Financial Stability Forum, the G20 and the IMF are looking at things called FSSAs, which are financial sector stability assessments, which are intended to assess the vulnerability of a country to a crisis. That is one element.

Backing that up is more general information on a country's compliance with standards and codes and so on that I referred to earlier. So that goes to the issue of transparency, and backing that up further—and this is another controversial element but nevertheless one that we have been pushing for some time—is disclosure by market participants themselves of their positions in markets. If you know that a large market participant has taken a particular position in a market, then that might give you some early warning that you have to be a bit worried about the prospect of that market participant leaving the market.

CHAIR—Could we get some more information on the UK bonds and the

Dr Henry—We will look at that, yes.

CHAIR—If you could. Following up that last point, you talk in your submission, I think, about the need not only for transparency but also to get integrated market assessments. How could you facilitate that?

Dr Henry—I think it is happening through the work of the Financial Stability Forum, the G20 and the IMF. These are early days in terms of the development of those financial sector stability assessments, but that will be the mechanism, I think. We, through the Manila Framework Group, will be proceeding with continued surveillance of macroeconomic policies in regional economies, but I think the question went more to financial sector vulnerabilities, and macroeconomic policies are only one element in that. That will be the instrument and that instrument has been endorsed recently by the G20 in its meeting in December of last year in Berlin.

CHAIR—Who coordinates Australian involvement in all of these different international fora?

Dr Henry—We do. Treasury coordinates the involvement. That does not mean that we sit on every one of these bodies. Australia's representative on the Financial Stability Forum is the Governor of the Reserve Bank, but we coordinate involvement in all of these international bodies.

Mr LATHAM—Can I raise two matters quickly. I support your submission's criticism of capital controls as an appropriate response to financial meltdown but, in light of those criticisms, how do we now look at the Malaysian experience?

Dr Henry—Our view on capital controls is that it actually goes more to the question of the pace of capital account liberalisation. Our view would be that the pace of capital account liberalisation should be attuned to the development or the sophistication of the financial infrastructure in the economy that is at issue. Malaysia was an interesting case because it reimposed capital controls on capital outflow. That is a very extreme position. We would not go so far as to rule that out. That is really the last thing you can imagine us endorsing

Mr LATHAM—Is that right?

Dr Henry—but we would say that there could be circumstances which are of sufficient concern that even something as extreme as that could be an appropriate vehicle.

Mr LATHAM—So you are not fully pure?

Dr Henry—We are absolutely pure.

Mr LATHAM—Absolutely pure?

Dr Henry—Absolutely pure.

Mr LATHAM—On that one matter! Finally, what is the logic of contagion? I think it was very useful earlier on when you pointed out that crises are not new, that the new thing is contagion. If markets are looking at blocs of countries as vulnerable and the contagion unfolds appropriately, isn't the logic of that to say, ‘Well, shouldn't these countries look at forming a currency bloc?’ If the market is now in the habit of looking at blocs of countries in their judgments, doesn't this strengthen the argument for blocs of currencies? Is this something that the Treasury supports? How do you see some of the suggestions that South American countries are going to dollarise and, if this does become an international trend beyond Europe, then where would Australia fit in?

Dr Henry—We do not have a hard and fast answer to that question. Our view would be that a currency bloc would demand some fairly extreme convergence of macroeconomic and microeconomic characteristics of the countries concerned. That was certainly the case in Europe and you would be aware of the development of the Maastricht criteria in Europe that were designed to achieve economic convergence before economic monetary union commenced. Those conditions were reasonably uncompromising, although I must say—and this is a personal comment—I wonder even now if they were sufficiently strict, and in any group of countries that you are looking at and speculating as to whether they were a candidate for a currency bloc, conditions of that sort would have to be satisfied.

But you raised the issue of contagion, and there is a question of whether the development of a currency bloc actually insulates a country from contagion. I think what it would probably do is just ensure that the contagion is automatic. If market players take a particular view on a country or on a bloc of countries and that affects the currency, then it would just automatically affect the currency of that trading bloc. The real problem with contagion, I think, is that you do not know for sure whether economy A will be perceived by the market to be so similar to economy B that it is going to be affected. You do not actually know that for sure. You are worried that if the domino topples then it might actually strike this domino, but you do not actually know it for sure. That is more the issue with contagion.

The development of currency blocs and dollarisation in Latin America and so on: you can understand I think why economies head down that road. There is a view, which is a very popular view that has come out of the Asian crisis, that there are only two sustainable exchange rate regimes—freely floating, which is Australia's case, or something which is at the very firm end of fixed. The two candidates that have been noted there are Currency Board arrangements such as Hong Kong has, for example; or dollarisation or some other firm tie—you just adopt the currency of another country.

We are not convinced by that. We can see that different exchange rate regimes might suit different countries at different times. We are not absolutely convinced that an exchange rate regime somewhere in between those polar extremes cannot be sustainable for a long period of time, and the reason we are not is because our view is that no matter what sort of exchange rate regime you have, what is important is not the exchange rate regime but the macroeconomic and microeconomic policies that the country is running and, as well, the institutional framework that that economy has.

We in Australia, I would like to think, would be running essentially the same disciplined approach to monetary policy, fiscal policy, structural reform, governance issues, that we would be running if we had a pegged exchange rate regime. I would hope that that would be the case, and I think it would actually be the case. At the end of the day, it is that set of macroeconomic and structural policies that is going to determine whether any particular exchange rate regime is sustainable.

Mr ALBANESE—I want to go to the distributional question which has been flagged a bit by Mrs Hull, and you have responded with the cobbler analogy. The Treasury's paper speaks about a trade-off that acknowledges that there is a potential trade-off between a more equal income distribution and a higher aggregate level of income, and you suggest interventionist measures in terms of tax and welfare policies in order to address that. You also claim that families on the bottom quantile have improved their relative position. I challenge that.

The figures seem to suggest that there has been a substantial growth in terms of the wealth inequality, particularly at the top band compared with the bottom band. I think the figure was 43.5 per cent, the richest 200 in the *BRW* survey out of GDP in 1983, and that had risen to 48.6 per cent by the end of 1998, which is the last figure. This seems to have occurred on a global scale as well, as part of people being left behind by the globalisation process.

Do you see there is a need to go a step further than just welfare and tax policies? Is there a need perhaps to adopt at times, or at least not dismiss, something that might be seen as economically irrational? Saul, I think, in his lecture last year pointed to 200 companies producing 27.1 per cent, I think it was, of the world's GDP and employing five per cent of the world's people. That disparity between people on the one level seems to me to be unsustainable if that process continues on a global scale. Don't you think there is some need for a greater addressing of that other than through tax and welfare policies?

Dr Henry—The short answer: no. I hope I understand the concern. I think I understand the concern. It is hard, though, to see how governments can intervene directly in markets to achieve a better outcome. That is the problem.

Mr ALBANESE—They can in part intervene by not withdrawing, for example, the government services from rural areas, which I am sure Mrs Hull is concerned with. Those conscious decisions to do something that might cost government more by having services in the bush and employing people, employing garbage sweepers on streets who would not be employed otherwise, rather than employing capital machinery. Those sorts of decisions.

Dr Henry—Sure. Governments can involve themselves in the delivery of services. There are many ways they can do that. They can do that either by participating themselves in the market as a supplier of goods or services or they can do that by paying somebody else to do it. Those two options are available. If you are talking about government involvement in telecommunications services to regional Australia, for example, government does not have to be a provider of telecommunication services. To achieve the result in which telecommunication services are available wherever you want them to be available, it is just a question of a contract being written with a private sector provider to do it.

Those things can be done, but our general comment would be that most of the distributional issues would be best handled by distributional policy—that is, taxation and spending policy. That is the point of it. The point of most taxation and spending policies of governments is, indeed, to effect income redistribution and that would seem to be the appropriate tool rather than through direct intervention in markets. I think you have given an example of an intervention in markets which is designed to achieve a social objective, and that is to have the government there providing the service.

Most government intervention in markets since the Depression would have been characterised as preventing people from doing things or making it more expensive for people to do things—for example, making it more expensive for business to hire labour by very high minimum wages. I am not characterising Australia here, but in Europe—not so much now—certainly there were periods of very high minimum wages. One should not be surprised that the net result is commensurately high rates of unemployment. Government activity post the Depression in a lot of countries was characterised by import controls, by controls on foreign capital, foreign investment and so on.

I am not saying there is absolutely no place for these things. In certain circumstances, for short periods of time, there could be, but I do not think we should believe that these things are welfare enhancing. I think the evidence is that these things are generally welfare detracting and that normally they create at least one other problem that governments then have to address, such as higher rates of unemployment which then have to be addressed through unemployment benefits and so on.

I think that each case of government involvement in markets should be addressed on its merits. I would not want to rule out that in certain cases that would be the most appropriate thing for governments to do. In fact, I have already referred to governments acting to deal with externalities through specific taxation arrangements or pricing regimes or, at the end of the day, direct regulation in particular markets. I would not rule that out at all but, by and large, the distributional consequences of globalisation would best be addressed through taxation and spending policies of government.

Mr ALBANESE—Would you see down the track any scope, in terms of international economic governance, for some form of international taxation, say, on capital transfers, income transfers?

Dr Henry—We would not rule that out at all. There is quite a lot of interest in that. There is a lot of interest in international cooperation on the taxation of capital. Indeed, there has been for a long time, and the Committee on Fiscal Affairs in the OECD has a lot of work under way that deals with the taxation arrangements for mobile capital. They do a lot of work on transfer pricing in particular. That is a big issue for Australia. They do a lot of work on trying to deal with tax havens. In the area of electronic commerce, there seems to me prima facie a similar case for multilateral cooperation on taxation arrangements, simply because it is very difficult with an e-commerce transaction to know exactly who is engaged on the other side of the transaction, where that person is domiciled, where the tax should be paid and so on. There are indeed big issues there to be addressed on a multilateral basis.

CHAIR—Dr Henry, we are almost out of time, and I think in that last answer you raise a whole host of issues which committee members might be rather keen to pursue. All those points you raise I think would be of great interest. Do you think we maybe could have another hearing to discuss those particular ones?

Mrs HULL—We would like that, because there is a whole host of issues there that I would like to further ask questions on.

CHAIR—It would certainly help us in the report, too. At this stage could I just thank you, Dr Horne, Dr O'Mara, Mr Johnston, Ms Spindler and Mr O'Brien, very much for coming along today. It has been a very valuable session and we certainly would appreciate it if we could have an opportunity to flesh out those issues you brought up at the end, because I think all of them, while not specifically addressed in your submission initially, are also of interest.

Proceedings suspended from 10.59 a.m. to 11.05 a.m.

CARNAHAN, Dr Michael, Branch Manager, LongTerm Budget Policy Unit, Department of Finance and Administration

CASSIDY, Mr John, Manager, Commonwealth Authorities and Companies Unit, Financial Framework Branch, Department of Finance and Administration

HAGEN, Mr Philip, Manager, Accounting Centre, Department of Finance and Administration

JACKSON, Mr Neville, Director, Accounting and Governance, Department of Finance and Administration

LEKAWSKI, Mr Edward, Economic Adviser, LongTerm Budget Policy Unit, Department of Finance and Administration

CHAIR—Welcome. The evidence that you give at the hearing today is considered to be part of the proceedings of parliament. Accordingly, any attempt to mislead the committee is a very serious matter and could amount to a contempt. The committee has received your submission No. 12 and it has been authorised for publication. Are there any corrections or amendments you would like to make to that submission?

Dr Carnahan—No.

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

Dr Carnahan—Just a very brief statement. The reason we made the submission is that Australia's recent reforms to fiscal policy processes have increased transparency and accountability and this has helped to insulate us from swings in market sentiments such as those the international financial markets can generate. This is in part because the fiscal regulations clearly illuminate the government's track record on fiscal policy and fiscal responsibility. What this means is that the government's move of the budget back into surplus is not simply a case of being fiscally responsible but being seen to be fiscally responsible, in this case by international financial markets.

We have touched on three different areas in the submission: the Financial Management and Accountability Act and the Commonwealth Authorities and Companies Act; the Charter of Budget Honesty, which provides a framework within which specific fiscal policy goals are set and reported against; and the accrual budgeting. They are the three major areas that we have identified which we believe lead to greater fiscal transparency. I am happy to go into any of those or take questions specifically.

CHAIR—Thanks for that. Let us start on the first point. You are talking about fiscal policy and budget surpluses and so on. We still seem to have a problem with household savings. While at the macro level we may be putting things right, we do not seem to necessarily be doing quite so well with the household savings area.

Dr Carnahan—The question of savings and any issues relating to a savings investment imbalance in the current account deficit are really more the bailiwick of Treasury than ours. Our focus is on the processes and the transparency of the processes of fiscal policy but, in terms of the settings and any savings investment imbalance, those are best addressed through the Treasury. They have the responsibility for the overall setting of economic policy.

CHAIR—Coming back to the budget surplus, what impact do you feel that is having on our international standing?

Dr Carnahan—The impact that we see it having is, in this instance and tying it in with broader fiscal confidence, a confidence impact. There are savings and investment issues and current account deficit issues which, as I said, are the bailiwick of the Treasury, but there are clear confidence effects associated with the way the market responds to what is perceived as a strong fiscal policy, both short term and long term. There is a short-term effect in the markets when any fiscal position is announced, but the longer term benefits associated with being insulated from swings in the economy through that market confidence again come about from a record of strong fiscal policy.

Mr LATHAM—What do you think could be done to improve transparency? If amendments could be made to the Charter of Budget Honesty, for instance, what sort of enhancements could we have, particularly compared to the Fiscal Responsibility Act in New Zealand, which seems to be somewhat more transparent and accountable than our first go at this process?

Dr Carnahan—I am not sure if my colleagues are familiar with the New Zealand example.

Mr LATHAM—In general, do you have any suggestions about how transparency could be strengthened? While the Charter of Budget Honesty has been useful, it is Australia's first cut at this process and the international experience shows that you learn as you go along and there might be some improvements that can be made.

Dr Carnahan—I do not have specific improvements. Part of the reason for that is that it has been in relatively recently and it is something that will be reviewed but, I am sorry, I do not have a specific—

Mr Hagen—Rather than improvements, perhaps we could highlight a little bit of what we are actually doing now, which is following the processes that are already in place. As far as transparency is concerned, on the reporting side of things we adhere to Australian accounting standards, for example, and we also have financial minister's orders under both CACA and FMAA which prescribe the requirements for reporting.

Relating that back to the budget, these reports are reporting on what has occurred in the budget, hence there is a link between the two. One of the tasks that the Department of Finance and Administration is undertaking at the moment is a constant review of the financial minister's order which prescribes the reporting requirements. We put a lot of emphasis on accountability and transparency in those orders, and they go an extra step. There is already a set of rules and regulations in place through the Australian accounting standards, and the things that those rules and regulations do not take into account we add through the financial minister's orders. In addition to that, as far as global harmonisation is concerned there is a proactive approach between the department of finance and the Australian Research Foundation to harmonise Australian accounting standards with international standards.

Mr LATHAM—In our recent hearing with the Governor of the Reserve Bank, it was raised that the forecast budget surplus for 2001 was some $500 million out of a budget of $160 billion. Was the Governor happy with this? He said, ‘Well, in theory, at this point of a long economic expansion you would expect a surplus to be much bigger than that.’ But he seemed to point out as part of the democratic process that as surpluses grow and as the cycle becomes longer, the public are saying, ‘Well, hang on, these are our funds. How about they come back to us in tax cuts or some other form of outlay?’ Does the department of finance share that concern that the surplus is too low for this part of the cycle and that there could be a management problem here within the political system as to how to sustain substantial surpluses throughout the economic cycle?

Dr Carnahan—You are quite right, there are a number of different pressures as outlined by the Governor and, I am sure, by Treasury on what size the surplus should be and how a surplus could be sustained over a long period of time. As I see it, the size of the surplus is a broad macroeconomic decision that the government has to make, and how large it should or should not be again is a broad macroeconomic decision. In terms of macroeconomic policy, I would defer to Treasury on that question. What we focus on is making sure that if we report a surplus, people know where that surplus comes from, and making sure that there is transparency in the calculation of the numbers—that people know what the numbers are about. But in terms of the broad settings of the surplus, that is not really our bailiwick.

Mr LATHAM—Everyone picks on Finance. I always thought you were a policymaking department that was driving a lot of these decisions. You get a lot of the blame for things you are not doing. Just on that question of transparency, what is your response to the Business Council of Australia's report on a more independent policy advice for the fiscal policy? They have come up with this discussion paper idea that the same sort of independence and transparency that applies to monetary policy might be considered in the case of fiscal policy, that there is some independent body that is giving advice to government. While this might be seen as a radical proposition, it was once thought that way about monetary policy.

In particular, the thing that I am interested in is the application that might have to regional economic issues. Maybe we do need some sort of advisory body in Australia that points out to government that, ‘This region is so depressed. Spending is so low and investment is so low. There needs to be some redirection of government funding, support, concessions, et cetera, to give it better prospects of economic growth.’ I am asking about two issues: (1) can transparency be improved by the sorts of suggestions that the BCA has made; and (2) is there some application of this independent advisory process that can be made to regional development issues?

Dr Carnahan—Taking your first question first, my understanding of the BCA proposal—and this is a very cursory understanding—is that they are proposing something very similar to an independent central bank. As you say, 25 years ago that was a ludicrous notion, yet now it is the norm within monetary policy. Conceptually it is a very interesting issue and it raises a whole host of concerns. The BCA have a broad structure, but you can play it out in any number of ways. I think we do ourselves a disservice if we do not consider all these conceptual ideas. How we ought to advise government on that is another issue but, as I said, conceptually it is fascinating.

The thing about a central bank is that it really has one policy lever. In the case of an independent fiscal authority you would have to ask yourself how many policy levers you would give it. In the crudest sort of situation you could give it a charter of setting the position of fiscal policy and, if you gave it that charter, that would be addressing some of the concerns you expressed in your previous question about, 'Should we be having surpluses?' or, 'Whenever we get a surplus, is it the case that they are very difficult to maintain over a long period of time?'

It is quite clear that if you had a central fiscal authority and you gave it a charter to set a surplus of a certain amount, in the same way that if you had an independent monetary authority with a charter to keep the inflation within a certain band, it may not be able to do that. Ironically, in the case of a fiscal authority it may have a stronger position if it is legislated to set a spending target. Should we go that way? It is such a radical change. We were not the first country with an independent central bank but we will be the first with an independent fiscal authority. It is certainly something that should be considered as one of the many interesting and useful conceptual changes that could be made. We have seen the proposal but we have not analysed it.

Taking your second question, you could drill down and give a charter more to do than just setting the level of the surplus or deficit, be it in a year or across a cycle or however you set up this legislation. Then you start to open up to very interesting politicoeconomic questions on the role of the government. If you had the fiscal authority with a set of rules to do certain things, depending on how far you drill down on your fiscal authority, you could drill down sufficiently and legislate and set it up in such a way that you do not need a budget process because the whole thing is set in stone. The problem you have there, of course, is that you do not have the flexibility when you start to set up a structure like that, so it is a balance between flexibility and certainty.

Mr LATHAM—What about these regional and neighbourhood effects? I am interested in how your department operates, because my perception would be that government sort of pours money into education services, health services, transport, all these sorts of silo services setups. I am curious as to what awareness there is within government on the outlay side, how they are all impacting at a local level, because a lot of the political action is about regional and neighbourhood effects. Let us take the case of Latrobe Valley. Latrobe Valley, from the Productivity Commission report, seems to be the one part of Australia that has gone backwards out of competition policy processes. Does central government have any awareness of what compensating policies are being put in place to assist that region's loss of spending power, loss of jobs, loss of investment? Has there been any redistribution of child care, education, health, transport, budgets that might be playing an offsetting role for Latrobe Valley? Do you have any such systems in place and would you regard them as desirable? People out in regions that have gone backwards are certainly looking for them.

Dr Carnahan—This is a very interesting question, but I am not quite sure how it relates to the matter that we are—

CHAIR—We do not have much time, but I am sure the committee would be interested in the answer.

Dr Carnahan—Let me see if I understand your question.

Mr LATHAM—Do you know what is happening in regions as the department supervises outlays or do you just see them go off into functional areas and that is it?

Dr Carnahan—I am not sufficiently across the specifics. I am happy to take on notice what sort of detailed, specific analysis is undertaken, but certainly at a broad level, the broad economic picture across Australia is not captured in one figure of GDP. There is an understanding that it is more complex than that.

Mr Lekawski—We do have feedback from line departments and the like. We have our agency managers, and the portfolio departments would know many of these effects that you are referring to. We do have close links with them and that would also feed up to us, so we do have avenues by which this does get fed to the department.

Mr LATHAM—There was a time when the Commonwealth published regional budgets. I know you have to go back to DRD in the 1970s. There was a time when regional budgets were published, but it sounds like we are a long way off that at the moment.

Ms GAMBARO—Going back to accrual accounting, in your submission on page 6 you say:

Under accrual budgeting it is possible to gain an insight into the intergenerational position of the government.

Can you expand on some of those issues and some of the advantages now under the system that we did not have before. You speak about results and outcomes based planning. Can you expand a little on how you are doing things these days.

Mr Hagen—I am sorry, I could not hear you very well, but I think you were mentioning the section on intergenerational in there.

Ms GAMBARO—Yes.

Mr Hagen—I think the big difference between the old cash accounting and accrual is that accrual reporting captures the economic transactions as they occur, regardless of when the cash flows happen. In the sorts of decisions on spending that are made now you would actually recognise the expense in that current year and acknowledge that the spending would occur in out years. So you know when the actual economic transaction occurs in the current period, but also what the impacts are in future years and perhaps even what has happened in the past because of that. Capital expenditure is now picked up with accrual reporting and budgeting. If a decision were made to improve the Commonwealth's infrastructure and masses of funds were to be injected into the economy over a long period of time, that decision would be reported in that one current year so that we would know that that amount of expenditure would occur in the future and we would have to plan for it. We would have to be responsible for the decisions that were made at that particular time rather than it being spread out over a number of years.

Ms GAMBARO—I think somebody asked earlier about consistency with processes, particularly international consistency. I know that it has taken a while to get to this stage. I know that Mark was asking about regional economies. I know skills shortages and programs probably does not come under your jurisdiction, but I am interested to know, again, about the feedback from regional spending in certain areas and programs. Your department does not actively get involved in that, from what I understood.

Dr Carnahan—Sorry? I am trying to understand the question.

Ms GAMBARO—I might just refer it to the chairman to write to you in more detail. That is really all I wanted to ask, Mr Chairman.

CHAIR—I want to come back to the question about what effect you feel globalisation has had on Australian sovereignty. There are various discussions on that, as to its possible reduction. Do you have a view on that?

Dr Carnahan—How are you defining 'sovereignty'? I am not quite sure what you mean by 'sovereignty'.

CHAIR—Sovereignty is obviously the level of control we have over our own affairs.

Dr Carnahan—Rather than impact on sovereignty per se, I think globalisation has led to consequences of decisions that are made. There is a greater impact from those decisions. For example, with globalisation the country can still make the decisions it wants to make, but with international capital movements the way they are certain decisions that a government may make may be responded to by the financial markets either positively or negatively. It has an indirect impact in that way.

CHAIR—That is sort of calling it by another name, isn't it? You are saying that, yes, it has had a—

Mr Lekawski—Globalisation has certainly increased the importance of transparency and the like, so in that sense I think it has been of benefit, in that even taxpayers now have a better picture of government expenses and how their moneys are being used.

Dr Carnahan—I think it is picking up the sort of thing that we think has occurred through the fiscal reforms. Globalisation has allowed Australia, with the fiscal reforms that have been taken recently, to have a competitive edge in the international market. It also depends on how you strictly define 'globalisation'. If you define it as a rapid movement of capital and technology, capital markets look favourably on certain decisions. With greater globalisation they have more freedom to act on those decisions, so the benefit of fiscal transparency is increased in a globalised environment.

Mrs HULL—Your submission basically is strongly against the reregulation of financial affairs. Could you outline in more detail what you think would happen if you went back into regulation of financial affairs.

Dr Carnahan—Which part of the submission are you referring to in that regard? We focus more on the financial affairs of the government.

Mrs HULL—Yes, that is right. Basically, if you were looking at accrual budgeting at the end of the line, if we were going back into non-accrual budgeting what would be the major downfalls of that?

Dr Carnahan—I do not think it is linear in that way. We have made a set of reforms. It is not like cash budgeting and then accrual budgeting is linear, another step. In terms of reregulating the affairs, it is a different way of doing business rather than reregulating it.

Mrs HULL—I am very much in favour of accrual budgeting. We used to have a budget and we all went out and spent our money prior to the end of the financial year. You had a budget and you basically put money to different areas in your portfolio as the end of the financial year approached, because there was really no incentive to contain that in order to make long-term predictions or long-term investment. Now you have an ability to have a long-term investment as a portfolio. In the scope of things, in the future do you see that being a great advantage to overcoming some of the issues of inequity that have been involved, basically, within Australia, with a financial emphasis?

Dr Carnahan—I am not sure I follow that.

Mrs HULL—Do you believe that there is more of an opportunity with accrual budgeting to be able to address financially, under a long-term process, some of the more outstanding needs in areas within Australia not so much internationally?

Dr Carnahan—Yes, I think there is. Accrual budgeting does two things. It puts more information together in one place so that when you are making your budgetary decision you have more information to make that on. I work from the premise that if you are making decisions on more information, you are more likely to get those priorities addressed.

Mr Hagen—I might add a little bit there, too. It comes back to the intergenerational and equity issue as well. For example, the consumption of assets: previously, under a cash budget, the consumption of assets was never accounted for and there was no planning done for the consumption of assets. So over a period of time the Commonwealth assets would be consumed and there would be no planning for it. Now, under accruals, we actually recognise and can plan for the consumption under depreciation. If we use Parliament House itself as an example, it is worth, say, $2 billion and over a 200-year period we would actually consume that asset. At the end it will be no longer suitable for its purpose and we will need to replace it. We actually can plan over that period of time to replace the asset. Probably Parliament House is not the best example, because it is 200 years, but if you—

Mrs HULL—That is an example of what I am speaking of.

Mr Hagen—Yes, but it is not just Parliament House, it is every asset that the Commonwealth controls, like our bridges, for example. We have funding for roads, and even though we do not directly report on the roads, it is a state issue—they report the same way as we do now under accruals, and budget for it. Because we fund them through our funding transfers, we build that into our budgets for forward years and, by recognising that we are consuming it now as an expense, we do not all of a sudden use up all those assets so that 10 or 20 years down the track some other generation has to pay for what we have consumed. With the new reporting and budgeting we are actually planning for that. I will give you an example, the Commonwealth bridges. If that had an expected useful life of, say, 20 years, that would be divided into—

Mrs HULL—Yes.

Mr Hagen—We would be providing funding for replacing those bridges over that particular period. They do not necessarily have to put it in a little jam jar. The organisation that is getting the funding, for example, can use it on any other asset, but their operating capability is maintained over that period of time now. Whether that is moneys invested or in another asset, it can be liquidated when the bridge needs to be replaced.

Mrs HULL—In the long term your national infrastructure, et cetera, can be planned for.

Mr Hagen—Yes.

Mrs HULL—So it gives you better ability to play in the international monetary market as well—

Mr Hagen—Exactly.

Mrs HULL—basically because you have recognised your ongoing costs.

Mr Hagen—Yes.

Mrs HULL—And that is something that we did not do before.

Mr Hagen—Exactly, and that is one of the huge improvements in accrual budgeting and reporting.

Mrs HULL—That is fantastic, thanks.

CHAIR—In your submission you talk about the Treasurer's transparency report. I was wondering whether any major weaknesses were revealed and how we rate overall.

Mr Lekawski—That one most definitely resides with Treasury. I am not trying to fob off the question, but we did make the point that this is yet another document that the government is putting forward to increase transparency. We are aware of the report and we have read through it, but as for weaknesses in that, I am sorry, I most definitely have to refer you to Treasury.

CHAIR—Are there any other questions? We have run a little shorter than I expected, but the committee has had a fairly long morning already.

Dr Carnahan—We have one narrow part of the policy framework. We gave you five pages, Treasury gave you 75 pages, so it is not surprising that there are not as many questions.

Resolved (on motion by **Mrs Hull**, seconded by **Mr Wilton**):

That this committee authorises publication, including publication on the parliamentary database, of the proof transcript of the evidence given before it at public hearing this day.

CHAIR—Thank you very much for coming before the committee, thank you for your submission, and thank you also to Hansard.

Committee adjourned at 11.35 a.m.