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26 SEP 2001

Mr D P M Hawker
Chair
House of Representatives
Standing Committee on Economics,
Finance and Public Administration
Parliament House
CANBERRA ~~ACT~~ 2600

Dear ~~Mr Hawker~~ David

The Government has recently given consideration to the recommendations outlined in the House of Representatives Standing Committee on Economics, Finance and Public Administration report on International Financial Markets : *Friends or Foes?* The response is expected to be tabled in Parliament shortly.

I would like to take this opportunity to thank the Committee for its report. You will be pleased to hear that a large number of the Committee's recommendations have been either implemented or are consistent with the Government's policy. This is due primarily to the significant progress in improving the international financial architecture over the period since the Committee commenced its inquiry.

The Committee recommended that the Government undertake a major study into the taxation regimes of our trading partners. In this regard the Government believes adequate consideration of other countries business taxation systems has already been undertaken as part of the Ralph Review of Business Taxation. In relation to derivatives exposure, while this will continue to be monitored, at this stage the Government believes that the existing corporations law and regulatory mechanisms are adequate. Consideration will continue to be given to the need for the establishment of a working group to look at transparency of derivatives exposure in light of ongoing developments in this area.

Yours sincerely

Costello

PETER COSTELLO

Copy to Bev

As C'tee no longer exists suggest hold over until after 10/11

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

INTERNATIONAL FINANCIAL MARKETS

FRIENDS OR FOES?

MARCH 2001

INTRODUCTION

Over the two years since the House of Representatives Standing Committee commenced its inquiry there has been significant progress in improving the international financial architecture, led by the work of the international financial institutions and other international policy groups. Consequently, a large number of the Committee's recommendations have been either implemented by the Government or are consistent with the Government's policy.

Australia has played a significant role in global policy developments through its active participation in international financial institutions (including the International Monetary Fund (IMF) and World Bank) as well as a number of other groupings. Australia is represented on the Group of 20 (G-20), the Financial Stability Forum (FSF) and a number of its Working Groups (the Working Group on Highly Leveraged Institutions, Study Group on Market Dynamics, the Task Force on Implementation of Standards, and the Follow-Up Group on Incentives to Foster Implementation of Standards). It has regularly attended the Bank for International Settlements' (BIS) Committee on the Global Financial System and its Committee of Experts on Gold and Foreign Exchange.

Australia has also contributed to discussions on regional issues through its presence at meetings of the Asia-Pacific Economic Cooperation (APEC), the Executive Meeting of East Asian and Pacific Central Banks (EMEAP), the Manila Framework Group (MFG), the Four and Six Markets Groups, and several committees which are convened by the BIS.

Australia has been at the forefront in implementing a number of the recommendations of international policy groups where they have been relevant to our financial environment.

ASIAN FINANCIAL CRISIS

RECOMMENDATION 1

The Committee recommends that the Government examine the feasibility of implementing those recommendations of the Group of 22 (G-22) Countries Working Groups where Australia is yet to reach world's best practice.

The Working Groups' recommendations have been taken up by Australian authorities. Australia conforms with the recommendations in almost all areas.

The Reserve Bank publishes its foreign exchange liquidity position, including forward commitments, on a monthly basis. Information on reserves, the external sector and international investment position are published in accordance with the International Monetary Fund's (IMF) Special Data Dissemination Standard template.

The Australian Bureau of Statistics (ABS) is to conduct a supplementary collection on foreign currency hedging, capturing foreign currency exposures of the financial and corporate sectors. Current plans are to publish the first collection, with reference period June 2001, later this year.

Statistics on overseas assets and liabilities of Australian banks have been provided on a regular basis to the Bank for International Settlements (BIS) over the past year, and publication by the BIS commenced in August 2000.

The Reserve Bank was an active participant in the drafting process for the Code of Good Practices on Transparency in Monetary and Financial Policies. Its practice conforms with the Code in all material respects. The most significant divergence is that good practice in some areas of accountability (such as publication of regular reports on the state of the economy and appearance before a parliamentary committee to report on the conduct of monetary policy) has been developed through convention rather than defined in legislation. Other minor divergences arise from the Reserve Bank not directly publishing Government overdrafts with the central bank (in the Australian system, these overdrafts are rare and very short-lived, with well-defined procedures for eliminating them quickly) and not publishing information regarding legal protection of officials and staff in the conduct of their duties.

Extensive work has been undertaken by international agencies on developing early warning systems and macroprudential indicators as tools for detecting vulnerabilities in a country's financial system. Australia supports this work, as a supplement to more comprehensive country analysis which takes into consideration institutional arrangements and other country-specific factors. The Reserve Bank monitors various indicators which may provide early information on imbalances and potential sources of instability in the financial system.

Australia's corporate insolvency laws are already consistent with most elements of the "Key Principles and Features of Insolvency Regimes" identified in the report of the Group of 22 (G-22) Working Group on International Financial Crises of October 1998. In those few areas where Australia's laws diverge from the G-22 Working Group's recommended approach, issues will be examined closely as part of ongoing work on insolvency matters.

The Committee recommends that high priority be given to achieving successful outcomes in the World Trade Organisation (WTO) negotiations on financial services.

The Government places a high priority on financial services negotiations in the World Trade Organisation (WTO). Accordingly, Australia submitted its initial WTO negotiating proposal for financial services in Geneva in March 2001, identifying the market access priorities on which Australia is seeking progress to be made during the financial services negotiations. This proposal picks up the need to address the barriers identified in paragraph 2.70 of the Committee's report.

EFFECTS OF THE GLOBALISATION OF INTERNATIONAL FINANCIAL MARKETS ON ECONOMIC POLICY

RECOMMENDATION 2

The Committee recommends that the Government continue to recognise the need to determine how employees and small businessmen displaced by the globalisation process can be assisted to make the transition to new employment.

Globalisation has delivered – and will continue to deliver - real benefits to those who participate in the international economy, reflected in the improved living standards and general welfare of the majority of the world's population. However, globalisation is not without its challenges, underscoring the need for sound domestic institutional structures along with competitive markets. The Government has an important role to play in fostering such an environment as well as minimising adjustment costs that may arise. Globalisation is, however, only one of a range of factors that can contribute to unemployment, including, declining firm and industry competitiveness, technological change, inadequate skills and education and training.

The Government has in place a number of general and specific assistance measures to help people make the transition to new employment.

General measures include Job Network, literacy and numeracy training, Work for the Dole projects and other aspects of mutual obligation, New Apprenticeships, Area Consultative Committees, the Regional Assistance Programme, the Small Business Enterprise Culture Programme, Business Incubators and other programmes. In addition, the Employee Entitlements Support Scheme assists displaced employees of firms which have become insolvent and are unable to pay employee entitlements, helping to tide former employees over until they obtain their next job.

Specific assistance measures include the Dairy Regional Assistance Programme, the Agriculture-Advancing Australia package and Action Agendas for a wide range of industries, such as the Textile, Clothing, Footwear and Leather Industry.

Such assistance has been strengthened in the 2001-02 Commonwealth Budget through the Australians Working Together package, involving overall spending of $1.7 billion over four years. The package includes special measures for mature age job seekers. The package also includes measures to improve articulation among programmes, a Working Credit which will allow people to accumulate, over time, a portion of the income test free area up to a total value of $1000 and a Literacy and Numeracy Training Supplement.

In addition to these measures, the Government will continue to monitor and analyse the effects of structural changes on the labour market.

The Committee recommends that the Government continue to explain what steps are being taken to reduce Australia's current account deficit.

The current account deficit (CAD) reflects the difference between domestic investment and saving. In order to achieve higher investment than can be funded domestically, Australia draws on foreign saving, either in the form of foreign borrowings or through foreign purchases of domestic assets. As long as domestic investment and saving decisions are not unnecessarily distorted by policy or fundamental failings, the CAD allows higher investment and hence higher growth. That is, CADs allow for productive investments in Australia that may not have been undertaken were reliance placed solely on domestic savings. Such investments provide for improvements in the economy's productive capacity, thereby allowing borrowing to be serviced without detracting from future living standards. In fact, higher investment should increase future living standards.

The Government does not attempt to target a particular CAD. Instead it has in place a policy framework aimed at delivering current account outcomes consistent with soundly based borrowing decisions. The Government's fiscal strategy, of budget balance on average over the course of the economic cycle, seeks to ensure that, over the medium term, the Government does not draw directly upon private savings. This means that the CAD, over time, should largely be based on private sector decisions subject to market disciplines. Furthermore, structural reforms implemented by the Government have built on past reforms to improve the quality of investment and saving decisions throughout the economy and should provide for more sustainable current account outcomes.

The Committee recommends that the Government carry out additional work on public discussion and the dissemination of information on the changes occurring in international financial markets.

Australia has, and will continue to be, actively involved in promoting the dissemination of information on international financial markets. This role, however, needs to be undertaken in a manner consistent with the work of international organisations such as the IMF, Financial Stability Forum (FSF) and the Group of 20 (G-20).

The Government supports the dissemination of information so that public discussion of the changes in financial markets is informed and up to date. Improved provision of information to markets and the broader public is a central element of the reform of the international financial system. Increased transparency of the international financial institutions and on-going progress in the implementation of standards and codes has greatly contributed to both the level and quality of information that is being made available to the public. The IMF has adopted a series of measures aimed at improving transparency and accountability, including the establishment of the Independent Evaluation Office (EVO) to provide an independent evaluation of IMF programs, polices and operations. Policies to enhance external communication, including the public release of internal reports, papers and policy documents have also been adopted by the IMF. The IMF and World Bank also conduct regular discussions with the private sector designed to raise awareness of standards and codes.

The Committee recommends that the Government determine whether additional measures are required to ensure that Australia does not experience a build-up of short-term foreign debt.

The Government recognises the potential dangers associated with a sharp build-up in short-term foreign debt. In this regard, one of the factors contributing to the evolution of recent financial crises was that countries pursued early and unbalanced financial liberalisation. Markets were opened to large volumes of capital flows without established financial and regulatory infrastructure. The risk and uncertainty associated with inadequate structures contributed to undue reliance on short-term capital flows and an increased susceptibility to shocks.

In Australia, the proportion of short-term debt in total debt liabilities has increased moderately, from around 45 per cent in 1996-97 to over 50 per cent in more recent quarters. These statistics, however, should not cause the kind of alarm that they caused in crisis-affected countries. In Australia, the increase in short-term debt is due, at least in part, to a compositional shift toward private debt (private sector debt is traditionally shorter term in nature than public debt). This reflects the current Government's program of fiscal consolidation.

In addition, there are a number of factors that applied to those countries hardest hit by the Asian financial crisis that are not applicable to Australia:

- Australia's capital accounts have long been liberalised, with debt issuance concentrated into a number of highly liquid benchmark lines along a yield curve extending out 12-13 years.
  - In deep financial markets such as Australia, longer-term debt instruments (eg. 10 year government bonds) are often as liquid as shorter-term instruments. Hence, in such markets, a change in the composition of debt towards short-term debt ought not to be interpreted in the same way as might be in the case of thinner, less liquid markets.
- Further, Australia is relatively well placed to service its debt obligations with the 2000-01 net income deficit – the overall cost of servicing foreign liabilities – forecast to fall to its lowest level as a share of GDP in well over a decade.

The Committee recommends that the Government determine what additional steps are needed to ensure that companies moving financial centres to Australia are able to employ the necessary specialists to staff those centres.

Australia offers companies moving financial centres to Australia a skilled workforce and a highly flexible education and training system that has demonstrated a capacity to respond effectively to changes in the demand for skills. The number of graduates with skills relevant to the finance sector, such as accountants, information technology and telecommunications specialists, and lawyers, has grown markedly over recent years.

With regard to information technology and telecommunications, the Government has put in place a whole-of-government strategy to meet the changing skill needs of industry by increasing the supply of information technology and telecommunications specialists and by upgrading and updating the skills of those within the industry. A key initiative is the establishment of the IT Skills Hub, which will have a strong emphasis on developing training courses for upgrading and retraining, and on promoting information technology and telecommunications careers and courses to people wishing to enter the industry.

In the financial sector, the Government has negotiated a number of migration agreements (notably Labour Agreements and Regional Headquarter Agreements) which provide for streamlined access to highly educated and skilled overseas workers to help meet the needs of employers. These arrangements are underpinned by commitments aimed at promoting employment and training opportunities for Australians within the industry.

The Government already has in place a range of migration arrangements to enable business and industry to obtain skilled overseas workers on a temporary and permanent basis to help address their skill needs. These arrangements recognise that Australian business must have access to skills, ideas, contacts and technology from overseas to be successful in an increasingly global economy.

The Government has also committed to promoting Australia as a Centre for Global Financial Services. Accordingly in 1999, the Government established Axiss Australia - a division within the Treasury - to promote, through marketing and facilitation, Australia's advantages as a location to conduct financial services business.

An important aspect of the work undertaken by Axiss Australia is to understand the process by which financial services firms (both Australian and international) determine the location for their financial services operations. To this end, Axiss Australia meets regularly with senior personnel of financial services companies. These discussions have identified skilled labour and the retention of specialist staff as being a key driver in the decision as to where to locate financial services operations.

In the specific area of financial services staff recruitment, Axiss Australia has, and continues to, explore new initiatives that promote financial services related education and training to those already working in the financial services industry, as well as to students at the primary, secondary and tertiary levels. Axiss seeks to consult with the Commonwealth Department of Education, Training and Youth Affairs (DETYA) on its activities in the education and training sector and also monitors trends in the financial services industry to identify potential areas of skills shortage.

RECOMMENDATION 3

The Committee recommends that a major study be undertaken to explore the impact of various taxation regimes in our major trading partners. The study should assess these regimes in the light of recent reforms to the Australian tax system.

The Government does not support this recommendation. The Ralph Review of Business Taxation gave consideration to other countries' business tax systems, including by commissioning a detailed report from Arthur Andersen entitled *An International Perspective*. Furthermore, the Treasury, as part of its function of providing taxation policy advice to the Government, has an ongoing responsibility to study and take account of overseas tax regimes and their implications for Australia.

TRANSPARENCY AND INFORMATION REQUIREMENTS

RECOMMENDATION 4

It is recommended that the Government continue to give high priority to assisting international efforts to improve the transparency and accountability of the international financial system and to expanding Australia's representation in the various international committees and working groups.

The Government supports this recommendation which is in keeping with efforts already underway by Australia at an international and regional level.

The Government recognises and supports the need for improved transparency and accountability to support the effective operation of the international financial system. A key component of this is to improve the transparency of programs and the operations of international financial institutions.

Improved transparency fosters better economic performance in several ways. Greater openness by member countries encourages more widespread analysis of policies and critically informs financial markets so they can operate in an orderly and efficient manner. It also leads to a more informed debate on policy as well as enhanced accountability of policy makers and increased credibility of polices.

Consistent with this, the Government has supported the IMF, and other organisations, in their efforts to promote greater fiscal, monetary and financial transparency. Australia was one of the first to undertake a self-assessment transparency report (now known as Report on the Observance of Standards and Codes (ROSC)) of Australia's compliance to international standards and codes. The Government has also encouraged increased transparency and accountability within the IMF, the World Bank and Asian Development Bank (ADB) themselves.

The Government is also committed to ensuring that Australia remains attractive to overseas investors and recognises that full disclosure is essential in maintaining confidence in the Australian market. The Government has already commenced a number of reforms such as the Financial Services Reform Package which is in keeping with improved transparency.

The Government supports Australia's involvement in relevant international committees and working groups. Australia is presently a member of a number of international groups including the IMF, World Bank, G-20, FSF (including various working groups), Asia-Pacific Economic Cooperation (APEC), the Executive Meeting of East Asian and Pacific Central Banks (EMEAP), the Manila Framework Group (MFG), the Four and Six Markets Groups, and several committees convened under the auspices of the BIS. Australia has made a significant contribution to these groups and the Government remains committed to continued active involvement.

INTERNATIONAL FINANCIAL ARCHITECTURE

RECOMMENDATION 5

The Committee recommends that Australia continue its strong support for the review of the International Financial Architecture with the aim of modernising its institutions and encourage Australian financial authorities to make the expertise of their experienced staff available to assist developing markets to reap the benefits of globalisation in world financial markets.

The Government supports this recommendation. Australia has been, and will continue to be, active in discussions on reform of the international financial architecture, including at the IMF, the G-20 and the FSF.

Australia has promoted efforts to enhance the effectiveness of the IMF through strengthening its crisis prevention and resolution capabilities. These reforms include streamlining Fund facilities to improve access, encouraging Fund members to adopt codes and standards - including for data dissemination, monetary policy, fiscal transparency, banking supervision, accounting and corporate governance - to encourage transparency and best practice, and establishing the Financial Sector Assessment Program (FSAP) to identify potential capital market weaknesses. The Fund is also continuing to improve its capacity to promote economic stability by examining how to refocus conditionality, developing a framework for involving the private sector in the prevention and resolution of crises and creating an International Capital Markets Department (ICM) to improve its understanding of financial market issues.

At a broad international level, Australia is an active participant in the FSF which was established by the Group of 7 (G-7) in February 1999 in response to the Asian financial crises. The FSF assesses vulnerabilities affecting the international financial system, identifies and oversees action needed to address these vulnerabilities and improves coordination and information exchange among the various authorities responsible for financial stability. Australia is also a member of the G-20 which provides a mechanism for informal dialogue in the framework of the Bretton Woods institutional system. The G-20 is designed to broaden the discussions on key economic and financial policy issues among systemically significant economies and promote cooperation to achieve stable and sustainable world economic growth that benefits all. Its agenda has included discussion of measures to reduce vulnerability to financial crisis and addressing the challenges of globalisation. Through the Australian Securities and Investments Commission (ASIC), Australia is an active member of International Organisation of Securities Commissions (IOSCO), the international securities regulators' cooperation and harmonisation forum. Internationalisation of securities markets, cross border enforcement, and cross-border settlement are major current work projects for IOSCO.

The Government is also committed to supporting regional development through a range of practical bilateral and institutional links. For example, Australia is actively engaging in APEC, which involves considerable assistance on capacity building to the region. In the area of economic and financial links, Australia is active in groupings such as the MFG, which reflects on developments in global and regional economies and provides a stronger voice to the growing economies of Asia. Through its regional training initiatives, such as the ASIC Summer School, Australia has been promoting harmonisation and the development of financial regulation infrastructure in our Asian neighbours.

Australia is also active in assisting other countries through a number of measures, including the provision of staff to train overseas supervisors in their home country, through training and secondments in Australia and providing staff from Australian financial authorities to participate in IMF programs and in bilateral arrangements. Technical assistance is provided to the region with a focus on individual institutional requirements and providing broader education and training services, knowledge and skills transfer, and capacity building. In particular, ASIC, the Australian Prudential Regulatory Authority (APRA), the Reserve Bank, the Australian Competition and Consumer Commission (ACCC), the Australian Taxation Office (ATO), AUSAID and the ABS provide a range of technical assistance and support.

The Government has also initiated a Mutual Recognition Project with Hong Kong and Singapore to enhance regional cooperative arrangements in the area of financial services regulation. The project aims to facilitate cross border flows of capital within the region and strengthen the ability of Australia and the Asian region to compete globally.

Furthermore, Australia is currently examining, in conjunction with overseas regulatory bodies, mechanisms for achieving mutual recognition in a range of specific areas. While the project is presently on a bilateral basis, it is foreseeable that any cooperation achieved could, over time, be extended to other jurisdictions in the Asian region.

ROLE OF HEDGE FUNDS (HIGHLY LEVERAGED INSTITUTIONS)

RECOMMENDATION 6

The Committee recommends that adoption of the proposals of the Financial Stability Forum (FSF) Working Group on Highly Leveraged Institutions should be given urgent consideration.

The Working Group's recommendations have been taken up by Australian authorities where relevant. Some aspects do not have much current practical relevance because there are no significant hedge funds based in Australia.

Sound practice towards highly leveraged institutions (HLIs) is incorporated into the supervisory approach of APRA, which requires financial institutions to assess and monitor all counterparty exposures and encourages institutions to undertake stress testing of exposures. Banks have improved their margining and collateral practices and improved their documentation. Banks and other counterparties have also reduced their exposure to HLIs.

Australia has well-developed market surveillance systems. APRA monitors the degree of leverage within the banking system. The Reserve Bank closely monitors financial markets in Australia, including the impact that rising leverage may have on market dynamics.

Good practice guidelines for foreign exchange trading have been compiled by a group of 16 private sector banks, including ANZ representing Australia. Many institutions have already adopted these guidelines.

Measures taken in Australia to build a firmer market infrastructure include the passage of legislation in 1998 to give legal certainty to close-out positions and robust access to collateral. Australia supports the UNCITRAL (United Nations Commission On International Trade Law) model law on cross-border insolvency and is working towards adopting the model provisions. Supporting the work of the Global Documentation Steering Committee, the Australian Financial Markets Association sets out standards, practices and legal documentation for use across a range of products. Recommended valuation and collateral practices are covered, with international documentation being used wherever appropriate.

The Government is highly supportive of the proposals relating to the need to improve risk management, capital adequacy regulation and disclosure practices. Improved risk management processes and enhanced disclosure across all institutions and a more sensitive capital adequacy regime will benefit financial systems more generally. The current work of the Basle Committee on Banking Supervision and the Multi-Disciplinary Working Group on Enhanced Disclosure is a major step in this direction.

Those recommendations made by the HLI Working Group but not directly taken up by the Australian authorities or international policy groups are stronger risk management by hedge funds and sustained industry progress in risk management. Nevertheless, according to a progress report in March 2001 of the Chairman of the HLI Working Group, these issues have been largely resolved within the industry. It found that the structure of the hedge fund industry itself has shifted in a way which has reduced many of the previous concerns about their activities. Although the number of hedge funds internationally has increased, their average size has decreased. In particular, many macro hedge funds – the funds considered to have caused the greatest market disruption in Asia during 1997 and 1998 – have either ceased operations entirely, or have been significantly scaled back. According to the report, this reflects "a reassessment of the risk-adjusted expected returns on large directional positions on asset prices" and "the industry perception that increased scrutiny of hedge fund investments would adversely affect potential returns". The report also suggests that market discipline on hedge funds has increased and the overall leverage of funds has fallen, again reducing the capacity of hedge funds to disrupt markets.

The HLI Working Group intends to conduct a further review of developments in the industry and its regulation in the first half of 2002. Australia will participate in this review.

DERIVATIVES

RECOMMENDATION 7

The Committee recommends that given the rapid growth in derivatives trading, the Treasury, the Australian Stock Exchange and the Sydney Futures Exchange should set up a working group to ensure that proper transparency regarding derivatives exposure is maintained by major public companies and financial institutions.

Australia's major public companies and financial institutions are subject to the disclosure requirements of the Corporations Law. These requirements include the preparation of annual financial reports in accordance with Australian accounting standards, the auditing of those reports and their circulation to company members. Public companies and financial institutions that are classified as disclosing entities are also required to prepare half-year financial reports and are subject to a continuous disclosure regime.

Among the standards that have to be complied with, is one dealing with the presentation and disclosure of financial instruments, including requirements for the disclosure of information about derivatives. In conjunction with its program to harmonise Australian and international accounting standards, the Australian standard setter will shortly be considering whether to adopt a recent international standard on recognition and measurement of financial instruments. It is also considering whether to participate in a convergence project with other national and international standard setters for the continued development of a comprehensive standard on accounting for financial instruments (based on an exposure draft issued late last year).

A further accounting standard on specific disclosures by financial institutions requires them to provide additional information about a range of matters, including contingent liabilities.

International regulatory bodies, including the Basle Committee on Banking Supervision, have also proposed increased disclosure for regulated financial institutions, which will involve prudential regulators requiring increased disclosure requirements. APRA has publicly supported these proposals. APRA already publishes aggregate data on the derivatives activities of authorised deposit taking institutions, and is currently developing new statistical collections which will assist in improving disclosure of the activities of financial institutions.

The Government will nevertheless consider whether there is a need to further enhance transparency in this area, including the desirability of establishing a working group on this matter.