The Parliament of the Commonwealth of Australia

International Financial Markets – Friends or Foes?

House of Representatives Standing Committee on Economics, Finance and Public Administration

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Forecasting is very difficult, especially if it is about the future.

(Anonymous)

Foreword

This inquiry stemmed from recognition by the Committee of the speed at which globalisation is proceeding in the field of international finance and that over the next few years, globalisation will have profound effects on Australia's financial arrangements.

Consequently, the Committee recognised that government fiscal and monetary policies must take the effects of globalisation into account and allow for the changing conditions it produces.

This has been a particularly challenging inquiry, covering issues which have an enormous scope. Recognising this, the Committee has kept a tight focus throughout the inquiry and has concentrated its investigations in the most appropriate and relevant areas.

The inquiry has examined the issues, in the main, from an Australian perspective. It has also touched on the very extensive work being undertaken by several international organisations. A topic of great interest was the Asian Financial Crisis and, in particular, the factors which enabled the Australian economy to continue growing strongly throughout that difficult period.

The Committee also looked closely at the activities of the large hedge funds. The attack on the Australian dollar by those funds in 1998, was a clear warning of the need for greater transparency in financial activities and the value of a sound prudential system.

In view of the rapid changes in this area and the scope of their effects, it is likely that the Committee will revisit this subject in the next Parliament.

David Hawker MP
Chair

Membership of the Committee

Chair	Mr D P M Hawker MP	
Deputy Chair	Mr G S Wilton MP (until 14/6/00)	Ms A E Burke MP (from29/6/00)
Members	Mr A N Albanese MP	Ms T Gambaro MP
	Mrs K E Hull MP	Mr M W Latham MP
	Ms T Plibersek MP	Mr C M Pyne MP
	Hon A M Somlyay MP	Dr A J Southcott MP

Committee Secretariat

Secretary	Ms B Forbes
Inquiry Secretary	Mr Tas Luttrell
Administrative Officers	Ms B Zolotto
	Ms S Ristevski
	Ms S Jurcevic

Terms of reference

On 30 March 1999 the Treasurer, the Hon Peter Costello MP, asked the Committee to inquire into:

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.

List of abbreviations

ASEAN	Association of South East Asian Nations
ASIC	Australian Securities and Investment Commission
ASX	Australian Stock Exchange
ATO	Australian Taxation Office
CLERP6	Corporate Law Economic Reform Program, Proposals for Reform Paper No.6
DFAT	Department of Foreign Affairs and Trade
DOFA	Department of Finance and Administration
EAAU	East Asia Analytical Unit in the Department of Foreign Affairs and Trade
G7	Group of 7 Countries
G22	Group of 22 Countries
GDP	Gross Domestic Product
GST	Goods and Services Tax
HLI	Highly Leveraged Institutions
HSBC	Hong Kong and Shanghai Banking Corporation
IFIs	International Financial Institutions
IFSA	Investment and Financial Services Association
IBM	International Business Machines

IMF	International Monetary Fund
IOSCO	International Organisation of Securities Commissions
JCPAA	Joint Committee on Public Accounts and Audit
OECD	Organisation for Economic Cooperation and Development, Paris
OTC	Over-the-counter derivative products
PERLS	Principal Exchange Rate Linked Security
RBA	Reserve Bank of Australia
SDDS	IMF Special Data Dissemination Standard
SFE	Sydney Futures Exchange
WTO	World Trade Organization

List of recommendations

1 Introduction

2 Asian financial crisis

Recommendation 1

The Committee recommends:

- that the Government examine the feasibility of implementing those recommendations of the Group of 22 Countries Working Groups where Australia is yet to reach world's best practice, including:
  - ⇒ the collection of information on the foreign exchange liquidity position of the public, financial and corporate sectors;
  - ⇒ the collection of data on the foreign currency exposure of the corporate sector;
  - ⇒ the Reserve bank to join other Reserve banks and the International Monetary Fund in drafting a code of best practices in monetary policy transparency;
  - ⇒ further improving Australia's risk management processes;
  - ⇒ providing banking statistics to the Bank for International Settlements;
  - ⇒ implementation of an early-warning system to deal with crises in the banking sector;
  - ⇒ further improvements to Australia's insolvency laws; and
- that high priority be given to achieving successful outcomes in the World Trade Organization negotiations on financial services.

(para 2.73)

3 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;

- continue to explain what steps are being taken to reduce Australia's current account deficit;

- carry out additional work on public discussion and the dissemination of information on the changes occurring in international financial markets;

- determine whether additional measures are required to ensure that Australia does not experience a build-up of short-term foreign debt; and

- 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. (para 3.76)

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. (para 3.77)

4 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. (para 4.55)

5 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;
- the Government 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. (para 5.54)

6 Role of hedge funds (highly leveraged institutions)

Recommendation 6

The Committee recommends that adoption of the proposals of the Financial Stability Forum Working Group on Highly Leveraged Institutions, should be given urgent consideration. The proposals are that there should be:

- stronger counterparty risk management;
- stronger risk management by hedge funds;
- enhanced regulatory oversight of Highly Leveraged Institution credit providers;
- greater risk sensitivity in bank capital adequacy regulation;
- sustained industry progress in risk management;
- a firmer market infrastructure;
- enhanced public disclosure by Highly Leveraged Institutions;
- enhanced public disclosure practices generally;
- enhanced national surveillance of financial market activity; and
- established good practice guidelines for foreign exchange trading. (para 6.44)

7 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. (para 7.38)

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Introduction

1.1 This inquiry on the effects of the globalisation of international financial markets on Australian Government policy, was referred to the Committee on 30 March 1999, by the Treasurer, the Hon Peter Costello MP.

1.2 The Committee had raised with the Treasurer its concerns about the implications for Australia's economic policy in the rapid growth in the extent, speed and sophistication of international financial markets, powered by recent rapid improvements in communications and information technology.

Background

1.3 The inquiry was intended to build on the groundwork carried out in 1998 by the Prime Minister's Task Force on International Financial Reform.

1.4 The Treasurer asked that the inquiry particularly consider the effects of globalisation on the conduct of macro-economic policies. The success of those policies in providing stable growth, is an important factor considered by the international financial markets when assessing Australia's attractiveness as a destination for investment funds.

1.5 This means that policy makers must consider the likely reaction of the international markets when formulating policy. Some observers see that as a healthy discipline but others see it as impinging on Australia's sovereignty in establishing its own independent policy goals.

1.6 The inquiry was asked to examine all of these issues and to consider the effects that volatility in international markets might have on economic policy.

1.7 Another issue for consideration was the need to improve the information available to the markets to ensure that their judgements about the Australian economy are soundly based.

1.8 A significant reason for undertaking the work was to enhance the understanding of these issues in the Parliament and the community.

Scope of the inquiry

1.9 On 30 March 1999 the Treasurer, the Hon Peter Costello MP, referred the terms of reference for the inquiry, as set out at page xiii.

1.10 In considering the effects of the globalisation of international financial markets on Australian economic policy, the Committee examined closely the Asian Financial Crisis and why Australia was able to avoid the worst effects of that crisis. It examined also the attempt by global hedge funds to force down the value of the Australian dollar in 1998.

1.11 The Committee considered how the changes in international markets had affected Australia's economic policy making process and what impact they had produced in the Australian market.

1.12 One of the main reasons cited for the severity of the Asian Crisis, was a lack of information available to investors and regulatory authorities. An area where this was particularly noticeable, was in the global trade in derivative products. The Committee looked at that sector of the market in some detail.

1.13 The international financial community is looking very closely at the structure of international financial arrangements – the so-called International Financial Architecture. The Committee examined Australia's contribution to this process and whether the transparency and prudential regulation applying to the Australian system, were up to world standards.

Conduct of the inquiry

1.14 The inquiry was advertised in the press on 14 April 1999 and the closing date for submissions was set at 21 May 1999. In addition, letters were sent to 142 financial institutions, companies and individuals, inviting them to make a submission to the inquiry. In response a total of 18 submissions were received. Although few in number, these were from the major players in the inquiry area (see Appendix A).

1.15 To flesh out issues discussed in these submissions, the Committee conducted four public hearings, two in Sydney and two in Canberra. A total of 28 witnesses appeared before the Committee at the public hearings (see Appendix C). Copies of the transcripts of these hearings are available on the Committee's internet site[1] or from the Secretariat.

1.16 A special feature of the inquiry was that a round-table conference, involving Committee members and members of the financial community, was held in Sydney on 9 November 1999. The Committee gratefully acknowledges the assistance of the Australian Financial Markets Association in making this conference possible. (see Appendix D for details of participants.)

1.17 The Committee also received private briefings from the Minister for Financial Services and Regulation, the Hon Joe Hockey MP, on 31 August 2000 and from Dr Nicholas Gruen, of Gruen Associates, on 29 June 2000 and from Dr Ross McLeod of ANU on 21 October 1999.

Structure of the report

1.18 Following this introductory chapter, Chapter 2 examines the onset of the Asian Financial Crisis and the speed with which it spread throughout Asia. The chapter also analyses why Australia was not as badly affected as other countries in very similar economic circumstances. Chapter 3 examines the implications of the international changes for Australia's economic policy–making process. It looks particularly at the effects on monetary and fiscal policy. Chapter 4 considers the need for transparency in financial operations and the information requirements for a sound and stable system. It assesses the Australian arrangements in this light. Chapter 5 looks at international efforts to review the International Financial Architecture and evaluates Australia's contribution to the process. Chapter 6, analyses the activities of hedge funds and looks particularly at their impact on the Australian financial scene. In a related area, the final chapter, Chapter 7 considers the rapid increase in the trade in derivative products and why they have posed problems for international financial markets.

1 http://www.aph.gov.au/house/committee/efpa/

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Asian financial crisis

2.1 The Committee examined closely the Asian Financial Crisis, which reduced the world's economic powerhouse to chaos in 1997-98. Australia's close linkages to the Asian economies and particularly their importance for Australian exports, made it essential that the causes of the upheaval should be fully understood.

2.2 The other aspect of the Crisis which drew the Committee's attention, was the ability of the Australian economy to absorb the shocks produced by the Crisis. It is important, the Committee said, to understand why other economies crumbled but Australia, with similar financial commitments and pressures to some of them, continued to grow strongly.

Background to the crisis

2.3 The Asian Financial Crisis produced deep-seated reactions of shock around the financial world. The reaction was linked, not so much to the fact that a crisis had occurred – the world community is used to that (two American economists identified 117 crises in 105 countries between 1971 and 1992[1]) – but that this crisis arose in what had been the fastest growing area in the world. Asia had promised to be the main engine of world growth into the new century but, to many observers, the crisis seemed to indicate that the area would be unable to live up to expectations. As the effects of the crisis spread beyond Asia into Russia and Brazil, there were fears of a world-wide breakdown of financial arrangements:

> The IMF found itself confronted with problems it never had to face before. The Asian crisis was a complex crisis, with a currency component and a credit component. The credit component, in

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1 Referred to in: Barry Bosworth, *The Asian Financial Crisis*, Brookings Review, Vol. 16(3), Summer 1998, p.7.

> turn, had an international aspect and a domestic aspect, and all the various components were interrelated. What made the Asian crisis different from any the IMF had faced before was that it originated in the private sector; the public sector was in relatively good shape.[2]

2.4 It is necessary to go back to the early 1990s to detect the origins of the Asian Financial Crisis. In that period low interest rates in the USA, combined with a period of economic growth in that country, channelled money into Asian stock-markets where higher returns were available. Similarly, investors from the depressed European and Japanese economies sought higher profit margins in Asia. All of these investors rated their risk level as very low; relying on the fact that the Asian currencies were pegged to the $US.

2.5 In discussions on international financial matters, one of the most debated topics is: 'what factors actually caused the Asian crisis to erupt?' In many cases the debaters have concluded that there were insoluble problems in the Asian economies and that the crisis was somehow inevitable. On the other hand, the Chief Economist of the World Bank, Joseph Stiglitz, argued that this thesis ignores the strengths and successes of the Asian economies, particularly those in East Asia. He was critical too of the tendency to automatically label any pre-existing economic or structural problem as a root cause of the crisis.[3]

2.6 There *were*, of course, a number of systemic weaknesses, and most commentators agree they *did* contribute to the crisis. Consequently, Stiglitz examined these in an effort to determine whether they were the only factors. He noted that financial sectors were weak, there were high levels of corporate debt and transparency was inadequate but he doubted whether these factors could "… *explain* the scope, timing and severity of the crisis."[4]

2.7 The Report of the Task Force on International Financial Reform, commissioned by the Australian Government, outlined the range of opinions:

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2 George Soros, *The Crisis of Global Capitalism*, Little, Brown & Company, London, 1998, p.146.

3 Joseph Stiglitz, Senior Vice-President and Chief Economist of the World Bank, *The Role of Financial Institutions in the Current Global Economy*, Address to the Chicago Council on Foreign Relations, Chicago, 27 February 1998, p.1 (http://www.worldbank.org/html/extdr/extme/jssp022798.htm)

4 Joseph Stiglitz, Senior Vice-President and Chief Economist of the World Bank, *The Role of Financial Institutions in the Current Global Economy*, Address to the Chicago Council on Foreign Relations, Chicago, 27 February 1998, p.2) http://www.worldbank.org/html/extdr/extme/jssp022798.htm

> Many saw the problem as stemming from policy shortcomings and structural problems in the emerging markets, although there were always concerns about contagion. Others focused on the potentially devastating effects of vast flows of short-term capital, as well as the inadequate risk assessment by the private sector. Some saw the response of the international financial institutions (IFIs) as inadequate and, indeed, contributing to the depth of the crisis. Attention has also focused on deficiencies in the financial supervisory arrangements in the developed economies.[5]

2.8 The Committee found that there is little common ground among the commentators looking at the Asian crisis. However, on one issue they all seem to agree – that the high proportion of capital inflows to Asia consisting of short-term investments, denominated in foreign currencies, was the catalyst which sparked the crisis. When the flow of funds was reversed, the financial systems of first Thailand, then Korea, Indonesia and Malaysia, revealed critical weaknesses both in their regulatory systems and the financial institutions themselves. Ross Garnaut has reported:

> The current account deficit [in Thailand, Malaysia and Indonesia] resulted from private investment exceeding private savings, and private domestic savings were reasonably large. The deficits could be seen, therefore, as the response to high levels of international direct and portfolio investment, encouraged by perceptions of high prospective profits and yields. The contribution to those perceptions of implicit guarantees of various kinds (including the promise of a steady relationship between the domestic currency and the US dollar) was rarely acknowledged. Nor was the potential for rapid change in perceptions about prospective returns on investment.
>
> … Once anxieties about asset prices and exchange rates began to precipitate a reversal of the large inflows of capital, the change of sentiment fed upon itself, eventually forcing the movement to floating rates and large depreciations.
>
> A conspicuous feature of the East Asian financial crisis is the extent to which financial institutions and other enterprises were exposed to foreign exchange risk. A high proportion of foreign liabilities had relatively short maturities. In normal conditions of continuing growth and economic stability, such loans would easily have been rolled over, but in the crisis conditions of the second

5 Task Force on International Financial Reform, *Report to the Prime Minister*, AGPS, Canberra, 1998, p.1.

> half of 1997, lenders insisted on immediate repayment at the crisis exchange rates.
>
> … The accumulation of large, uncovered foreign liabilities reflected imprudences on the part of several parties: borrowers and their owners; domestic banks and other lenders; and foreign lenders and portfolio investors. How was imprudence possible on such a large scale? Lack of transparency about corporate financial affairs and the ineffective prudential supervision of banks both contributed. So did the presence of implicit guarantees on exchange rates, bank safety, and sometimes other business parameters. 'Moral hazard' might have played a role, influenced by an expectation that public international support would become available to offset losses that might be incurred in the worst of circumstances.[6]

2.9 The inflow of foreign capital contributed to a boom in bank and non-bank credit to the private sector. In Thailand, Indonesia, Malaysia and the Philippines particularly, this credit expansion outstripped the already rapid growth of the economy. When the foreign investors began to withdraw and credit conditions were tightened, the construction boom came to an end, real estate prices fell and the number of non-performing bank loans began to increase. In turn, these problems were compounded by speculative attacks on the currencies of several Asian countries.[7]

2.10 As observed above, a key problem stemmed from the proportion of investments in East and South-East Asia which involved short-term credit. For example, the IMF estimates that from 1994-96 short-term loans to Thailand reached 7-10% of GDP, while foreign direct investment was only 1%. In all, the International Monetary Fund (IMF) estimates that by the end of 1996 $US 624 billion had been lent to East Asian countries, much of it as short-term debt.[8]

2.11 The IMF summarised the conditions leading to the crisis, as follows:

> A combination of inadequate financial sector supervision, poor assessment and management of financial risk, and the maintenance of relatively fixed exchange rates led banks and corporations to borrow large amounts of international capital, much of it short term, denominated in foreign currency and

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6 Ross Garnaut, *Overview*, in Eds Ross H. McLeod and Ross Garnaut, *East Asia in Crisis: From being a miracle to needing one?*, Routledge, London, 1998, pp. 13, 16-18.

7 Gerhard Aschinger, *An Economic Analysis of the East Asia Crisis*, Intereconomics, March-April 1998, p.56.

8 Nayan Chanda, *Rebuilding Asia*, Far Eastern Economic Review, 12 February 1998, p.47.

> unhedged. As time went on, this inflow of foreign capital tended to be used to finance poorer-quality investments.[9]

2.12 In his article *Rebuilding Asia,* Nayan Chanda commented that "foreign banks frequently lent blindly, with little or no due diligence." He quoted a European bank official as saying:

> … all banks are under certain competitive pressure. If the market is attractive you go with the herd. Even if you have doubts you don't stop lending.[10]

Such a comment has an all too familiar ring in relation to the end of economic booms.

2.13 The IMF, in its report *International Capital Markets* released in September 1998, said that the crisis:

> … followed a period characterised by record private capital inflows into the emerging markets and a relatively sharp compression of spreads[11] across a wide range of emerging market credit instruments.[12]

The spread of the crisis

2.14 In early 1997 concerns were already emerging about the narrowing of spreads for borrowers in the emerging Asian markets and the likelihood of the flow of capital reversing itself.[13]

2.15 On 2 July 1997, Thailand severed the link which foreign investors had relied upon – the baht's peg to the $US – and the Bank of Thailand withdrew its support for the currency. Within a few hours the baht had fallen 15% against the $US and the crisis was under way. In the next few

9 International Monetary Fund, *The IMF's Response to the Asian Crisis*, 17 January 1999, p.1. http://www.imf.org/External/np/exr/facts/asia.HTM

10 Nayan Chanda, *Rebuilding Asia*, Far Eastern Economic Review, 12 February 1998, p.47.

11 Spread: The difference in a quotation between buying and selling prices. A large spread normally indicates inactive trading of a product. *Reuters Glossary of International Financial & Economic Terms*, Edited by the Senior Staff of Reuters Limited, Longman Group Limited, Essex, UK, 3rd Edition, 1994, p.118.

12 International Monetary Fund, *International Capital Markets: Developments, Prospects, and Key Policy Issues*, World Economic and Financial Surveys, by an IMF Staff Team, International Monetary Fund, Washington, September 1998, p.1.

13 International Monetary Fund, *International Capital Markets: Developments, Prospects, and Key Policy Issues*, World Economic and Financial Surveys, by an IMF Staff Team, International Monetary Fund, Washington, September 1998, p.1.

months it spread across East and South-East Asia, triggering currency collapses and widespread business failures.[14]

2.16 During the second half of 1997, several other Asian countries severed the link between their currency and the $US. One after the other, those currencies began to depreciate. Intense pressure was suffered in turn by Malaysia, the Philippines and Indonesia. Next Singapore's currency was weakened and then Hong Kong SAR and Korea were affected.[15]

2.17 The extent of the crisis can be gauged by the fact that at their low point in January 1998, currency depreciations had reached extraordinary levels by comparison with the situation in July 1997. The Indonesian rupiah had fallen by 81%, the Malaysian ringgit by 46% and the Thai baht by 55%. The Korean won suffered a similar fall of 55% between October and late December 1997. Average levels of exchange rate volatility increased by a factor of 10 compared to the previous year, during the second half of 1997. Transactions costs rose dramatically in the spot, forward and other derivatives markets and liquidity dropped.[16]

2.18 Professor L. Krause of the University of California, observed that although the crisis was triggered by the Thai depreciation, there were underlying weaknesses in several countries which were the direct causes of the crisis. He commented that "an international financial and economic crisis occurs only when both domestic and foreign investors lose confidence in the foreign exchange value of a currency." In the case of Asia, several regional currencies had become overvalued during the 1990s, the countries involved were recording large and growing current account imbalances and official foreign currency reserves were insufficient to withstand an attack by currency speculators.[17]

2.19 Reviewing the events leading up to the crisis, Professor Krause highlighted the fundamental causes of any financial crisis and their relationship to the Asian crisis in 1997-98:

> … One must look to a combination of factors to explain the Asian financial crisis. It may well be that four factors were involved and *all* must be present for a crisis to be triggered.

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14 Nayan Chanda, *Rebuilding Asia*, Far Eastern Economic Review, 12 February 1998, p.46

15 International Monetary Fund, *International Capital Markets: Developments, Prospects, and Key Policy Issues*, Washington, September 1998, p.2.

16 International Monetary Fund, *International Capital Markets: Developments, Prospects, and Key Policy Issues*, Washington, September 1998, p.1.

17 Professor Emeritus Lawrence B. Krause, *The Economics and Politics of the Asian Financial Crisis of 1997-98*, report prepared for the Council on Foreign Relations, p.3. http://www.cfr.org/public/pubs/crisis.html

> The first factor … is that a currency is significantly overvalued. This can only happen if the monetary authorities are unwilling to let the currency depreciate in a timely and orderly manner.
>
> The second factor … is a rapid and substantial build-up of short-term foreign debt. If a current account deficit is entirely financed with … an inflow of real long-term capital …, then the soundness of a currency is rarely questioned. … In contrast, if short-term borrowing is relied upon … then serious concerns are raised as to whether the debt can be repaid. … Short-term debts are constantly being reviewed and can reverse direction quickly. Thus if short-term capital is being relied upon and access to additional amounts begins to be problematic, then the conditions for a reverse flow are created that can initiate a currency crisis.
>
> The third factor is disarray of public finances, or the existence of fragile private domestic financial institutions. In [Asia] … the private finance companies and banks were fragile, and their condition combined with weak prudential oversight by their governments.
>
> Political uncertainty is … rarely appreciated as a necessary condition for the triggering of a financial and economic crisis. Markets clearly do reflect political variables. When politics change, markets react. Investors and speculators will become uncertain when they cannot anticipate the economic policy that will be implemented.[18]

2.20 A major problem which emerged and served to deepen the crisis, was the discovery that the foreign currency debts of Asian companies were much greater than had been suspected. The reporting system put in place after the Latin-American crisis in the 1980's, and intended to eliminate this problem, failed to work.

2.21 Lester Thurow writing about the Asian crisis in 1998, commented:

> While everyone knew that accounting systems were a little squishy on the Pacific Rim, everyone had been surprised by just how fraudulent they really were.[19]

2.22 Thurow went on to note as examples, that:

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18 Professor Emeritus Lawrence B. Krause, *The Economics and Politics of the Asian Financial Crisis of 1997-98*, report prepared for the Council on Foreign Relations, pp. 3-5. http://www.cfr.org/public/pubs/crisis.html

19 Lester Thurow, *Asia: The Collapse and the Cure*, The New York Review, 5 February 1998, Section 4.

- a major Japanese financial house had been allowed to keep $US 2.6 billion in losses off its books – with the knowledge of the Japanese Ministry of Finance; and
- the Korean Central Bank reported as national currency reserves, funds which had already been lent to Korean companies to repay $US denominated loans.[20]

2.23 These weaknesses added to the existing negative impressions of foreign investors and in 1997 Asia's capital inflow began to reverse itself. The 1990s had seen continuous strong inflows of capital to the Asian economies. In 1997, however, private capital flows into the countries first affected by the crisis fell by $US 100 billion. Predictably, the reductions mainly affected short-term international bank credit and portfolio flows. In the last part of 1997 bank lending collapsed. Foreign direct investment was less affected because for those funds, longer term factors are more important.[21]

2.24 The IMF, analysing the origins of the crisis, noted that the problems in Asia were not primarily caused by macroeconomic imbalances but were mainly the result of weaknesses in financial systems and failures in governance.[22]

2.25 In addition, the high level of foreign currency denominated debt led the IMF to say that the depreciations:

> … seriously impaired the balance sheets of already weak and unhedged domestic financial institutions and corporates and led to sharp increases in credit risk.[23]

2.26 The Department of Foreign Affairs and Trade's East Asia Analytical Unit (DFAT EAAU) in a report on Asia's Financial Markets, also recognised these weaknesses and set out the problem areas in the financial sector in some detail:

> … in many regional economies, financial sectors formed the weak link in development strategies. Because many financial sectors were protected from foreign and domestic competition, regulated poorly or subject to government credit allocation and interest rate intervention, they often were inefficient, poorly capitalised and

20 Lester Thurow, *Asia: The Collapse and the Cure*, The New York Review, 5 February 1998, Section 4.

21 International Monetary Fund, *International Capital Markets: Developments, Prospects, and Key Policy Issues,* Washington, September 1998, p.3.

22 International Monetary Fund, *The IMF's Response to the Asian Crisis*, 17 January 1999, p.1. http://www.imf.org/External/np/exr/facts/asia.HTM

23 International Monetary Fund, *International Capital Markets: Developments, Prospects, and Key Policy Issues,* Washington, September 1998, p.3.

> weak in managing risk. Private and state owned banks dominated financial activity at the expense of capital markets and non-bank financial institutions. Banks often made capital available to favoured sectors and borrowers; lending was based on connections rather than sound credit risk analyses. Consequently, many financial institutions were highly leveraged after lending to risky private and public projects. Heavy, often undiscriminating, international capital flows into these financial sectors exacerbated risks.[24]

2.27 The problems were further complicated by the continuing weakness of the Japanese economy. Japan had long been relied upon as a strong source of investment funding by the Asian economies. In 1997, under the pressure of domestic weaknesses, Japanese investors withdrew from the regional economies.[25]

2.28 The group of countries which were first, and hardest, hit by the Asian Crisis, displayed a wide variety of economic conditions. In an interview an IMF official, Karen Lissakers, described the situation in Thailand as acute overheating and asset inflation, added to a rapidly expanding foreign debt. Whereas in Korea, she said, while there was some overheating, the economy had actually slowed in 1997. Also, Korea did not have a huge foreign debt, although the proportion of short-term debt was high. A particular problem in Korea was that the true position of the banking system was not revealed by the supervisory and accounting systems. Indonesia exhibited elements of all of the Korean and Thai problems. The main debt problem here was corporate indebtedness, however, rather than short-term debt threatening the banking system.[26]

2.29 Fears for the entire international financial system surfaced when the contagion spread beyond the Asian region. In October 1997 after Korea had been drawn into the crisis, pressure began to mount on Brazil and Russia because Korean banks were selling off Brazilian and Russian bonds. There were also some market reports of bank exposures through off-balance sheet derivative transactions but the information available is scanty.

2.30 The Committee noted that the glaring weakness in the Asian economies at the outbreak of the Asian Crisis was their exposure to short term debt. The problem was compounded because much of that debt was written in

24 East Asia Analytical Unit, *Asia's Financial Markets: Capitalising on Reform*, Department of Foreign Affairs and Trade, Canberra, 1999, p.13.

25 International Monetary Fund, *International Capital Markets: Developments, Prospects, and Key Policy Issues*, Washington, September 1998, p.3.

26 Karin Lissakers, US Executive Director, IMF, *The IMF and Reforming the Global Financial Architecture*, interview p 3. http://www.usia.gov/journals/ites/0898/ijee/ejfliss.htm

foreign currencies and unprotected by hedging arrangements in the market. When Asian currencies began to depreciate, the burden of that foreign currency debt began to rise and the situation quickly became untenable. With the benefit of hindsight, we can see that, yet again, the dangers of the herd mentality have been demonstrated, as in similar periods of financial excesses in the past.

2.31 The other weaknesses which became apparent, were the over-extension of individual financial institutions and the level of bad debts within the system. The Committee considered that one of the keys to Australia's resistance to the shock of the Crisis, was the standard of regulation and prudential supervision in the Australian financial system. The high standards in these areas prevented the problems of over-extension and an excessive level of bad debts from emerging.

2.32 Although the Australian economy performed well during the Asian Crisis, the period was not without its challenges. When the Committee examined the effects of the Crisis on Australia, it found that the economy had exhibited a remarkable degree of resilience in dealing with the problems caused by the chaos in some of its major trading partners.

Australia's experience

2.33 The Committee recalled that when the Asian crisis struck, there was widespread alarm in Australia. It was thought that the volatility of currency markets would infect the $A and that the economic difficulties in some of our major export markets would lead Australia into the same sort of difficulties as our Asian neighbours.

2.34 However, in reality, the Committee found that the Australian economy coped very well with the Asian crisis. Despite an attack on the currency and drastic reductions in trade with Asian markets, Australia emerged as an economy which promised stability in the midst of the Asian turmoil. Other countries began to look at the Australian economy for ways in which they might insulate themselves against future crises. American economist Paul Krugman described the Australian economy as the 'miracle economy of the region'.[27]

2.35 The Reserve Bank unequivocally indicated the flexible exchange rate as the main reason for the Australian economy's resilience in the crisis:

> … does the country have a risk management strategy to avoid having the sort of things happen to us that happened to a number

27 Submission No.13, The Treasury, p.26.

> of these Asian countries? In fact, we have a risk management strategy … which is responsible for the reason that we did not get into trouble. The major component of that … is a floating exchange rate. When we look at what happened in Asia, the countries that had the most severe difficulties had a fixed exchange rate or semi-fixed exchange rate. The countries that did best had floating exchange rates, Australia being the best example. I think the reason Singapore did better than Hong Kong was that Singapore let their currency move and Hong Kong could not; Taiwan did quite well.[28]

2.36 Dr John Edwards of The Hong Kong and Shanghai Banking Corporation (HSBC), in his evidence to the Committee, supported the Reserve Bank view and said:

> I am in complete unanimity with the view the Reserve bank Governor has put to this Committee … that the strength of the Australian banking system was tremendously important – its strength and reliability, its success in internal prudential controls, and the success of its supervisory institutions – as well as the floating Australian dollar.[29]

2.37 In evidence, ASIC offered three additional reasons why Australia was able to withstand the main stresses of the Asian crisis:

> One is that we have well-established securities and futures markets that have a long history of both self-regulation and regulation under the Corporations Law, we have well-established markets and well-established practices within those markets for the supervision of market activity.
>
> Secondly, the communication between regulators and exchanges domestically and internationally works quite well. …
>
> … We have subsequently done further work, both within ASIC and between ASIC and the exchanges, on developing protocols for dealing with market break-outs of any kind, …
>
> Thirdly, on the regulatory framework, the legislative regime in Australia came out fairly well … It is robust. It deals with many things that were not in place in other jurisdictions and it showed itself to be a calm, comprehensive and effective regulatory framework, able to get to grips with the problems that are often associated with sudden market break-outs.[30]

28 Evidence, Reserve Bank of Australia, 9 February 2000, p.5.

29 Evidence, Dr J. Edwards, 22 March 2000, p.96.

30 Evidence, Australian Securities and Investments Commission, 22 March 2000, p.61.

2.38 ASIC continued that, rather than any single factor, it was a combination of things which allowed Australia to cope with the crisis:

> … the sophistication of the participants, the robustness of the regulatory framework in which things take place and, in effect, the long and relatively deep experience of those with regulatory or supervisory responsibilities.[31]

2.39 The Treasury submission also addressed the reasons for Australia's success in dealing with the crisis:

> The robustness of the current policy framework has been 'stress-tested' in the aftermath of the financial crisis that emerged in East Asia in late 1997. This resulted in a severe economic downturn in many of our major trading partners in the region, and a large fall in world commodity prices.
>
> In the past, such developments might have created severe difficulties for Australia. Indeed, many observers expected that Australia would experience a serious economic downturn on this occasion.[32]

2.40 The Treasury point of view was that because of the structural reforms in Australia over the past fifteen years, the anticipated problems were contained much better than they had been during past crises. Currency depreciation did not cause inflation. The current account deficit was offset by a fiscal surplus and a sound microeconomic environment, so that private sector investment did not suffer. As a result, foreign investor confidence in Australia was retained and Australia was able to benefit from increased international competitiveness.[33]

2.41 Treasury also listed a number of other factors which reduced Australia's vulnerability:

- the stabilisation of Australia's net foreign debt to GDP ratio;
- reduction of the net debt-servicing ratio to 10% of exports, the lowest since 1984;
- Australia's foreign currency denominated liabilities are now outweighed by foreign currency assets;
- the public share of net external debt also at its lowest since 1984;
- over 70% of short-term debt is held by the Reserve Bank and prudentially-regulated depositary corporations.[34]

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31 Evidence, Australian Securities and Investments Commission, 22 March 2000, p.62.

32 Submission No.13, The Treasury, p.30.

33 Submission No.13, The Treasury, pp.27 & 30.

34 Submission No.13, The Treasury, pp.30-1.

2.42 The Committee concurs and emphasises the importance of all of these factors, including well established political stability and the expectation of responsible government in maintaining confidence in our economy. The strength of our democratic systems – the separation of powers between an elected parliament and the judiciary, plus the freedom of the media – are all very significant factors and not to be taken for granted. The ability to change government without disruption of government processes, is a very valuable asset.

2.43 One tangible result of Australia's success, is that countries in the region are showing an increasing interest in studying the Australian system. The Australian Securities and Investment Commission (ASIC) and the Reserve Bank both reported an increasing involvement in technical assistance to the region[35]. In evidence also, the Bank made reference to its activities in regional forums and its assistance to smaller countries in the region.[36]

Recovery from the crisis

2.44 The DFAT EAAU considered that by late 1999, the main economic variables in the region had made a substantial recovery. The Unit indicated that positive growth had returned, exchange rates had stabilised, interest rates were down and current account deficits were disappearing.[37]

2.45 Investment advisers Morgan Stanley Dean Witter, in a paper in May 2000, were extremely positive about recent progress in Asia. The paper forecast GDP growth of 6.7% for non-Japan Asia in 2000-01. It noted also that there were encouraging signs that the region's governments were tackling the heavy task of structural reform.[38]

2.46 In general terms, most of the economies in the region have made a fairly rapid recovery. The Reserve bank commented:

> I think the good news for Australia is that Asia is back and growing again, with a question mark still about Japan and, of course, a question mark about Indonesia, but by and large most of

35 Evidence, Australian Securities and Investments Commission, 22 March 2000, p.62 and *Reserve Bank of Australia, Annual Report 2000*, Reserve Bank of Australia, Sydney, 3 August 2000, pp.24-5.

36 Evidence, Reserve Bank of Australia, 9 February 2000, p.13.

37 East Asia Analytical Unit, *Asia's Financial Markets: Capitalising on Reform*, Department of Foreign Affairs and Trade, Canberra, 1999, p.13.

38 Morgan Stanley Dean Witter & Co., *A New Asia Emerges*, in Global: Daily Economic Comment, May 10, 2000, New York, p.2.

> our big trading partners are back and growing again. That is good for Australia. We can get on with developing the sorts of businesses and the connections with Asia that we were doing in the past.[39]

2.47 Similar thoughts were expressed in an article in the Business Review Weekly, just prior to September's World Economic Summit 2000. The author said that recovery in Korea, Singapore, Malaysia and Hong Kong had set off a 'chain reaction'. The article said that the region (excluding Japan) is expected to grow by 6.8% this year and over 6% next year. It noted that even Japan, after ten years of stagnation, is expected to increase its growth rate from 0.6% last year to 1.5% in 2000 and nearly 2% next year. The leaders in this recovery are: Korea (7.5%), and Taiwan (6%), plus continuing high rates of growth in India and China, which were less affected by the Asian Crisis. Indonesia, struggling with its political problems, and the Philippines (large budget deficits and security concerns) are the exceptions.[40]

2.48 The EAAU suggested that a number of factors combined to boost growth in 1999. The Unit listed eight major points contributing to this outcome:

- capital flight was exhausted by the end of 1998;
- large trade surpluses were being achieved and rebuilding of reserves was under way;
- trade financing had resumed in most economies;
- monetary conditions had loosened and real interest rates had fallen;
- as interest rates fell, the excessive inventory contraction of 1998 halted;
- rising budget deficits provided a fiscal stimulus;
- consumer confidence and spending was returning in some economies; and
- substantial excess industrial capacity was allowing production and exports to expand without new investment.[41]

2.49 The Committee said that the proposed Asian Regional Financial Arrangement is an encouraging initiative, which could assist the recovery of confidence in the region. This arrangement would involve Japan, China, Korea and the Association of South East Asian Nations (ASEAN)10[42] in a network of currency swaps designed to provide a backstop to defend against future speculative attacks on the region's

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39 Evidence, Reserve Bank of Australia, 9 February 2000, p.14.

40 Tom Skotnicki, *Asia Looms Even Larger*, Business Review Weekly, Friday, 8 September 2000, p.52.

41 East Asia Analytical Unit, *Asia's Financial Markets: Capitalising on Reform,* Department of Foreign Affairs and Trade, Canberra, 1999, p.36.

42 The ASEAN 10 includes: Singapore, Malaysia, Thailand, Indonesia, the Philippines, Brunei, Cambodia, Laos, Myanmar and Vietnam.

currencies. The proposed members have available more than $US 700 billion in foreign exchange reserves. In addition, Hong Kong and Taiwan hold over $US 200 billion which might also be utilised to augment the network.[43]

2.50 Full recovery of the Asian financial systems, however, will take some years. The EAAU report on Asia's Financial Markets pointed out that the reforms needed – restructuring of financial sectors, writing off non-performing loans, recapitalisation of the banks and restructuring of corporate debt – will require enormous work, especially in Indonesia and Thailand and, to a lesser extent, Malaysia and Korea.[44]

2.51 The Governments in the region also face the task of reinforcing their economies to withstand future shocks. According to the EAAU, this task will involve structural reform, strengthening regulation and supervision of the financial markets, opening financial sectors to competition, upgrading bankruptcy procedures and improving financial sector infrastructure. These tasks will not be completed quickly, although the Asian Regional Financial Arrangement mentioned above would be a valuable step forward.[45]

2.52 The Australian Treasurer, Mr Costello, said:

> Although all of the major regional economies are now improving, the strength of the recovery across the region varies. … We expect that Asia's growth will continue this year and next, supported by the strength of activity in the world economy. But the challenge Asia faces is to put in place the framework to ensure sustained economic growth.[46]

2.53 Despite the array of tasks still to be done, the Committee said, there is an air of optimism that the Asian crisis is, in fact, behind us. One commentator noted, however, that even if that is true, the stresses of the crisis have left their mark:

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43 Morgan Stanley Dean Witter & Co., *A New Asia Emerges,* in Global: Daily Economic Comment, May 10, 2000, New York, p.2.

44 East Asia Analytical Unit, *Asia's Financial Markets: Capitalising on Reform,* Department of Foreign Affairs and Trade, Canberra, 1999, p.13.

45 East Asia Analytical Unit, *Asia's Financial Markets: Capitalising on Reform,* Department of Foreign Affairs and Trade, Canberra, 1999, p.13.

46 Mr Peter Costello, The Treasurer, *Learn the Lessons, Seize the Opportunities,* BusinessReview Weekly, Friday, 8 September 2000, p.53.

> … Although most economists say the Asian recovery is well entrenched, in some ways it is a new Asia, tempered by the reality of its most serious and sustained downturn for at least 30 years.[47]

2.54 The Committee is a little more cautious than the commentators. There are encouraging signs of growth but the continued sluggishness of the Japanese economy is a worrying factor. Until they agree to restructure, their growth prospects remain hampered. The Committee is also concerned at the likely effect on Asia as the US economy slows down. Many of the Asian economies are relying on the strength of the US economy to help them back to sustained growth.

2.55 In addition, there are unresolved problems of financial reconstruction and elimination of bad debts in the banking systems of countries, such as Thailand and Korea, which were badly affected by the Crisis.

2.56 Overall, the Committee is hopeful that enough has been done in these areas to prevent a slump back into the crisis conditions. For the recovery to be firmly based, however, it will require a much stronger performance from Japan and for the Crisis countries to move quickly on the restructuring of their banking systems. It will also require improved prudential arrangements in the Crisis countries to support the restructuring process and avoid any repetition of the pre-Crisis conditions.

Capital controls

2.57 In the years after World War 2 when the Bretton Woods Agreements were drawn up, capital controls were a widely used and accepted method for a country to control the flow of overseas investment funds.

2.58 When the Bretton Woods arrangements collapsed, countries began to abandon the use of capital controls. By the onset of the Asian Crisis they were a rarity. Consequently, when Malaysia decided to introduce capital controls on capital outflows[48], in an attempt to quarantine the Malaysian economy from the effects of the crisis, it was widely criticised for the move.

2.59 In its evidence to the Committee, the Reserve Bank declined to join in the criticism of Malaysia. The Bank said:

> I do not think in any way that Malaysia should be seen as some sort of pariah just because they chose that particular way of

47 Tom Skotnicki, *Asia Looms Even Larger*, Business Review Weekly, Friday, 8 September 2000, p.53.

48 Submission 13, The Treasury, p.44.

> solving the crisis. I think it is very interesting that they did. It is going to give people a nice experiment to study in years to come, to see whether that was … better than the path that, say, Thailand adopted. But I do not think there was anything hostile in them choosing that path.[49]

2.60 Treasury also presented the view that the decision on whether capital controls should be applied "should be attuned to the development or the sophistication of the financial infrastructure in the economy that is at issue." Treasury regarded the move by Malaysia as an extreme position but also indicated that the idea could not be ruled out entirely. It was, however, "the last thing you can imagine us endorsing", according to Treasury:

> … 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.[50]

2.61 Dr John Edwards said that Australia has in the past used capital controls quite successfully and Chile has used similar policies. In the Asian crisis, Malaysia was the only successful example and Russia's attempt to impose controls ended in disaster. He explained that Malaysia was dealing with a vastly different situation to Russia. Investment in Malaysia was largely long-term capital investment, while Russia was dealing with short-term speculative funds. As Dr Edwards put it: "Japanese firms went in there [Malaysia] and built factories which they could not take away – whereas Russia's was entirely short-term obligations."[51]

2.62 The Treasury summarised the arguments by saying that in certain circumstances there could be an argument for measures such as capital controls - but warned that they tend to result in some other problem, which the Government must then address:

> I am not saying that 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.[52]

49 Evidence, Reserve Bank of Australia, 9 February 2000, p.12.
50 Evidence, The Treasury, 13 March 2000, p.48.
51 Evidence, Dr J. Edwards, 22March 2000, pp.101-2.
52 Evidence, The Treasury, 13 March 2000, p.49.

2.63 In its submission, Treasury explained that while capital controls may be effective in providing a breathing space in difficult circumstances, they do have some drawbacks. They can impose additional costs on long-term investments as well as the short-term funds which are the target. They can also create a more uncertain investment environment, increase the perceived level of risk and thereby discourage the roll-over of funds and new investment flows.[53]

2.64 Over all, Treasury believes that capital controls can only be justified in exceptional circumstances and should only operate as a temporary measure until reconstruction and strengthening of the financial system has been achieved.[54]

Action required

2.65 Although the Australian economy emerged almost unscathed from the Asian Crisis, there is a continuing need for structural reform to continue in this country. The Treasury submission made it clear that the primary need is for continued productivity growth, increasing flexibility and greater competition in the Australian economy.[55]

2.66 As a first step towards further progress in the financial system, the Prime Minister's Task Force on International Financial Reform compared Australia's arrangements with the recommendations of three Working Groups set up by the G22[56] countries. These Groups examined what the world financial system needs to do in three areas: transparency and accountability; strengthening financial systems; and international financial crises.[57]

2.67 The Task Force found that Australia's arrangements compared favourably with the recommendations put forward by the three Working Groups. The Task Force Report recommended that Australia use its expertise to ensure that the momentum of reform is maintained, that the emerging

53 Submission 13, The Treasury, p.46.

54 Submission 13, The Treasury, p.46.

55 Submission No.13, The Treasury, p.31.

56 G22 consisted at first of: Australia, the G7, Argentina, Brazil, China, Hong Kong-SAR, India, Indonesia, Korea, Malaysia, Mexico, Poland, Russia, Singapore, South Africa and Thailand. At the second (and last) meeting of the Group, the Netherlands, Belgium, Switzerland and Sweden were also included. See Reserve Bank comment in Evidence, 9 February 2000, p.9.

57 Task Force on International Financial Reform, *Report to the Prime Minister*, AGPS, Canberra, 1998, pp. 37-42.

markets be given special attention (especially in Asia) and that the private sector should be encouraged to take part in progressing reform.[58]

2.68 While the Task Force found that in most instances Australia's arrangements met the requirements of the Working Group recommendations, there are a few areas where some action is still needed. For example:

- the collection of information on the foreign exchange liquidity position of the public, financial and corporate sectors;
- the collection of data on the foreign currency exposure of the corporate sector;
- the Reserve bank to join other Reserve banks and the IMF in drafting a code of best practices in monetary policy transparency;
- Australia's risk management processes need further improvement and development;
- providing banking statistics to the Bank for International Settlements;
- implementation of an early-warning system[59] to deal with crises in the banking sector; and
- some areas of Australia's insolvency laws.

2.69 The DFAT EAAU Report on Asian Financial Markets also called attention to the need to maintain progress. It commented that the damage suffered by the Asian economies emphasises "the importance of ongoing vigilance to ensure that Australia maintains a world best practice financial sector regulatory framework, and continues microeconomic reform".[60]

2.70 The EAAU reported that an important priority should be support for Australia's negotiations in the World Trade Organization talks on financial services. The EAAU highlighted several areas where the outcomes will be important for Australia:

- more operating licenses for Australian financial service providers;
- more transparent licensing criteria;
- fewer restrictions on the form of commercial establishment;
- higher levels of foreign equity participation;
- greater freedom for companies to employ their own personnel; and
- more flexibility in the type of products foreign firms can offer.[61]

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58 Task Force on International Financial Reform, *Report to the Prime Minister*, AGPS, Canberra, 1998, pp.3-4.

59 The Task force on International Financial Reform described this as: "Adoption and implementation of a method of structured early intervention in the banking sector – which includes mechanisms to ensure a consistent and timely response by supervisors." Task Force on International Financial Reform, *Report to the Prime Minister*, AGPS, Canberra, 1998, p.40.

60 East Asia Analytical Unit, *Asia's Financial Markets: Capitalising on Reform,* Department of Foreign Affairs and Trade, Canberra, 1999, p.339.

61 East Asia Analytical Unit, *Asia's Financial Markets: Capitalising on Reform,* Department of Foreign Affairs and Trade, Canberra, 1999, p.339.

2.71 The Committee commends the assessment of Australia's financial system. It is clear, however, that the rapidly changing world financial conditions do not allow for complacency. As the pace of globalisation increases, the Committee said, the time frame for important prudential decisions shortens rapidly. For Australia to keep pace, it must continually improve its systems and the supervision of those systems.

2.72 The Committee's opinion was that the Australian system should be brought up to world's best practice in all areas of regulation and supervision as soon as possible. Implementation of the following recommendations would be an important step along that path, the Committee said.

Recommendation 1

2.73 **The Committee recommends:**

- **that the Government examine the feasibility of implementing those recommendations of the Group of 22 Countries Working Groups where Australia is yet to reach world's best practice, including:**
  - ⇒ **the collection of information on the foreign exchange liquidity position of the public, financial and corporate sectors;**
  - ⇒ **the collection of data on the foreign currency exposure of the corporate sector;**
  - ⇒ **the Reserve bank to join other Reserve banks and the International Monetary Fund in drafting a code of best practices in monetary policy transparency;**
  - ⇒ **further improving Australia's risk management processes;**
  - ⇒ **providing banking statistics to the Bank for International Settlements;**
  - ⇒ **implementation of an early-warning system[62] to deal with crises in the banking sector;**
  - ⇒ **further improvements to Australia's insolvency laws; and**
- **that high priority be given to achieving successful outcomes in the World Trade Organization negotiations on financial services**

62 See definition at footnote 59.

3

Effects of the globalisation of international financial markets on economic policy

3.1 The effects of the Asian Financial Crisis were a timely reminder for Australia that in today's globalised financial system no country can truly operate independently. Major economic decisions are scrutinised in detail by world markets and can have an immediate effect on currency and share values.

3.2 This means that the rapid progress of world economic integration poses a growing series of challenges for government policy makers. The Treasury submission to this inquiry noted that:

> The driving elements of economic activity – capital markets, technical innovation, corporate organisation, and trends in consumer demand – are increasingly crossing national boundaries as governments, societies, firms and individuals strive to maximise the advantages presented to them by economic integration.
>
> These developments –loosely termed as 'globalisation' – offer real benefits to those who participate in the international economy. Globalisation, however, also poses real risks as decision-makers, in government and business, adjust to an ever-more complex economic environment.[1]

3.3 In his evidence to the Committee, Dr John Edwards commented that the trend was towards major economic decisions being taken by "shifting coalitions of nation states, regulators [and] global institutions." He

1 Submission 13, The Treasury, p.1.

wondered whether this might be an opportunity for smaller players like Australia, to have an important role in the process.[2]

3.4 Dr Edwards speculated that in the long term, economic globalisation "is really about creating a single global economy in which, over time, nation states are deprived of former functions." He added that the debate over what nation states are and what they should do, could be under way within a decade. He concluded:

> … what I really mean is that the only economic power of successful globalisation is achieved by merging your economy with others.[3]

Dealing with global financial markets

3.5 An area of government activity especially affected by the changes in global financial arrangements, particularly by the recent spectacular advances in the speed of communications, is the control of national financial systems. The rapid changes in international financial markets and the increasing speed of international transactions, have made the continuation of a completely independent policy virtually impossible for any length of time.

3.6 The growth of trans-national companies, the world-wide spread of Internet access, the availability of virtually instantaneous funds transfer (with all of these linked to twenty-four hour a day access to stock and currency markets around the world) have presented economic administrators with major problems in controlling the stability of their national systems:

> Financial markets have become interconnected in several ways. First of all, on-line transactions and computer-based information systems allow for very fast movements of capital between financial products, currencies and countries – often in a matter of seconds. Second, new financial products have appeared, mixing valuables from various countries to be traded in other countries. When one component of these products is affected by a sudden change in value in one market, it affects the product as a whole, in a range of markets. This was particularly the case of derivatives in Asian financial markets in 1997. Third, speculative investors looking for

2 Evidence, Dr J. Edwards, 22 March 2000, p.99.

3 Evidence, Dr J. Edwards, 22 March 2000, p.100.

> high financial rewards move swiftly from one market to another, trying to anticipate price movements of different products in different currencies, using forecasting models.[4]

3.7 In particular, the volatility of short-term speculative investment funds has tested the ability and resolve of regulatory authorities several times in recent years. The rapid movement of these funds and the instability it brings, were features of the onset of the Asian Crisis of 1997-98. It characterised what has been called "the first global crisis of the Internet era."

3.8 One of the catchcries of those opposed to globalisation, is that the process reduces a government's ability to maintain control of its own economy. The Treasury claims that Australia's performance during the Asian Crisis has weakened this argument. Strong economic fundamentals have proved to be a good insulating mechanism against the more dramatic fluctuations of global financial markets but, as Treasury acknowledges, the market is quite able to punish those economies pursuing inappropriate policies.[5]

3.9 To be effective and to be accepted as appropriate by world financial markets – what author Thomas Friedman calls the electronic herd[6] – policies must be soundly based, credible and transparent. Treasury suggests they must be supported by a strategy which minimises the opportunities for capricious and arbitrary actions in the market to undermine them. Fortunately, "there appears to be very little conflict between what is valued by international financial markets and what is in Australia's best interests," according to Treasury's assessment.[7]

3.10 Critics claim, however, that globalisation introduces distortions into the economy, such as widening the dispersion of income and interfering with employment growth. Treasury said that it is unfortunate that often the real potential for globalisation to improve welfare, both nationally and internationally, is overlooked by its critics.[8]

3.11 It must be recognised, of course, that any major structural change is going to affect some individuals and businesses badly. There is a very positive role for government to play in redressing this situation. The globalisation process involves the movement of scarce resources into sectors yielding the highest return and the strongest and most stable employment growth.

4 Manuel Castells, *Information Technology and Global Capitalism*, in Eds Will Hutton and Anthony Giddens, On The Edge: Living with Global Capitalism, Jonathan Cape, London, 2000, p.55.

5 Submission 13, The Treasury, pp.1-2.

6 Thomas Friedman, *The Lexus and the Olive Tree*, Harper Collins, London, 1999, p.94

7 Submission 13, The Treasury, pp.1-2.

8 Submission 13, The Treasury, p.7.

To balance this process, there is a need for assistance to those directly affected, especially those who need retraining or relocating and those employees too old to change careers.[9]

3.12 The Committee asked Treasury directly whether the globalisation of international financial markets reduces the government's scope for independent policymaking, Treasury responded: "No, it does not." After explaining that globalisation today is not much different from similar circumstances at the end of the 19th century and the beginning of the 20th century, except in the speed of communications and the size of gross capital flows, Treasury said:

> 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.[10]

3.13 The Committee does not fully share Treasury's optimism about the independence of policy making as far as macroeconomic policy is concerned. The evidence shows that macroeconomic policy is converging around the world and that international financial markets react badly to unsatisfactory policies, such as large budget deficits.

3.14 Treasury then explained that what international investors look for in the Australian (or any other) economy, is strong, sustainable growth that does not give rise to inflationary pressures or unsustainable current account deficits. If asked what Australia would like to see in its economic performance, Treasury said, "we would say much the same thing" and concluded that:

> … 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

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9 Submission 13, The Treasury, p.31.

10 Evidence, The Treasury, 13 March 2000, p.40.

> international financial markets. It is difficult to run an argument that there is something wrong with that discipline.[11]

A similar conclusion could be drawn from the experiences of State governments in recent years.

Effects on monetary and fiscal policies

3.15 Australia's current monetary and fiscal policies were developed in response to the growing internationalisation of the economy. The spread of globalisation, bringing with it increased mobility of capital flows, demanded a policy solution which could provide both:

- integration with the world economy; and
- stability.

3.16 Treasury's submission highlighted the dangers for the Australian economy in the increased level of volatility in international capital flows. If the international instability affected the Australian market, it could increase business and investment uncertainty, lead to higher risk premiums on equity and long-term debt, deter foreign trade and long-term direct investment and, possibly, increase the risk of financial system failure.[12]

3.17 Those reasons alone were sufficient to justify a close examination of Australia's monetary and fiscal policies. In 1997-98, however, an additional incentive was added. As the Asian Crisis spread, the international markets began to bracket Australia with countries suffering severe difficulties – Korea, Indonesia, Russia and Brazil. It became essential to demonstrate the soundness and stability of the Australian economy.[13]

Monetary policy

3.18 In the period from the 1960s to the early 1990s, under pressures generated by changes in international markets, monetary policy in Australia went through several transformations. By the mid-1980s, a consensus of opinion was forming that monetary policy was the instrument best equipped to deal with inflation – which had been a nagging problem in

11 Evidence, The Treasury, 13 March 2000, p.40.
12 Submission 13, The Treasury, p.22.
13 Submission 13, The Treasury, p.22.

the Australian economy. Inflation was, Treasury said, "regarded as an obstacle to sustained economic development."[14]

3.19 In 1993, reflecting the Government's wish to reduce Australia's inflation rate, the Reserve Bank announced that it would aim to keep inflation between 2 and 3 per cent over the course of the economic cycle. Treasury's submission notes that adopting an inflation target provides direction for monetary policy decisions and adds two related benefits:

- a solid basis for inflationary expectations (reducing speculation); and
- greater certainty in economic decision-making.[15]

3.20 In 1997, in a paper describing inflation targeting, the Reserve Bank explained that there had been a general shift in a range of countries, to the adoption of inflation targeting as a central part of their monetary policy. The Bank outlined the reasons why control of inflation was so widely seen as a necessary goal:

> Medium-term price stability is widely accepted as the appropriate ultimate goal for monetary policy. This reflects two ideas. The first is that high rates of inflation distort decision-making, ultimately leading to slower economic growth. The second is that monetary policy is the most effective instrument in influencing medium-term inflation outcomes. By pursuing a strategy that ensures that inflation does not distort decisions concerning investment, production and savings, monetary policy is best able to contribute to sustainable improvements in living standards.[16]

3.21 The changes in monetary policy were reinforced in 1996 by an agreement between the Treasurer and the Governor of the Reserve Bank, released publicly as a *Statement on the Conduct of Monetary Policy*[17]. The statement formalised the inflation target of 2-3 per cent over the cycle and clearly recognised the independence of the Reserve Bank in setting monetary policy. At this time the arrangement was also established for the Reserve Bank Governor to appear before the House Economics Committee twice a year, to discuss the Bank's handling of monetary policy. The Bank undertook to release just before each of these hearings, a *Semi-Annual Statement on Monetary Policy* which would form a basis for the discussion at the hearing.

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14 Submission 13, The Treasury, p.67.

15 Submission 13, The Treasury, pp.68-9.

16 Reserve Bank of Australia, *Monetary Policy and Inflation Targeting*, Bulletin, October 1997, JS MacMillan, Sydney, p.14. http://www.rba.gov.au/bulletin/bu_oct97/bu_1097_3.pdf

17 *Reserve Bank of Australia, Report and Financial Statements*, Reserve Bank of Australia, Sydney, 30 June 1997, pp. 8-10.

3.22 The Australian economy has shown the benefits of these policy changes in its ability to sustain nine years of continuous growth. Several times in the past, periods of sustained economic growth have been prematurely ended by a rapid increase in inflation. The Reserve Bank said that long sustainable expansions can only be achieved with low inflation levels – where high inflation occurs, the economic expansion does not last.[18]

3.23 To avoid the problem of high inflation, the Reserve Bank has departed from previous practice in the last year, by moving to increase interest rates before inflationary pressures have fully developed, rather than react to a pre-existing problem. This strategy is designed to relieve any inflationary pressure without undermining the growth trend in the economy. To date the strategy has been successful and inflation has been kept within the Reserve Bank's target range – although in the last two or three months there have been concerns that external factors may be pushing the level of inflation up.

3.24 The Committee found that there was concern in recent months over the unexpected weakness of the $A. With the economy still growing quite rapidly and the economic fundamentals still very sound, the Committee said there was no apparent reason for the dollar's dramatic slide to record lows on international exchanges. Most commentators ascribe the problem to the continuing strength of the $US but that does not explain why the $A has also lost ground against a range of other, less dynamic, currencies.

Fiscal policy

3.25 Like monetary policy, Australia's fiscal policy went through a period of uncertainty in the 1970s and 1980s. Treasury's submission referred to a lack of clarity in the fiscal policy framework through that period. It said that at the beginning of the 1990s, this lack of certainty led to the application of a risk premium to debt instruments issued by the Australian Government. This, in turn, affected the risk ratings in the private sector.[19]

3.26 Treasury said in that early part of the 1990s, Australia was dealing with a substantial deterioration in its fiscal position. The problem stemmed from the economy's sluggish recovery from recession and the resultant decline in the budget position.[20]

18 Evidence, Reserve Bank of Australia, p.13.

19 Submission 13, The Treasury, p.68.

20 Submission 13, The Treasury, p.69.

3.27 Concerns over the state of fiscal policy increased when the current account deficit almost doubled. In 1994-5 it stood at almost 6 per cent of GDP. Further concerns arose from an increase in underlying inflation and a widening of the long-term bond rate differential between the US and Australia. Treasury's submission indicated what seemed to be a weakness in the policy framework at this time:

> One shortcoming of the fiscal policy framework over this period was the lack of a clearly articulated framework linking fiscal policy objectives with national saving and current account goals. There was no clear statement of what fiscal policy should be aiming to do over a longer period, and why.[21]

3.28 The outcome was the introduction of a new medium-term fiscal strategy in the 1996-7 budget. The new strategy required an underlying budget balance to be maintained over the course of the economic cycle. An important feature was the decision to retire Commonwealth debt as quickly as possible. This effectively removed Commonwealth borrowings as a contributor to the current account deficit. A *Charter of Budget Honesty* was also introduced[22], requiring the Government to outline its fiscal objectives and to publicly release estimates twice a year and before each election.[23]

Policy performance

3.29 The last fifteen years have seen Australia's monetary and fiscal policies substantially restructured. Internationally those changes have been seen as very successful. The Australian economy's resilience in dealing with the effects of the Asian Crisis drew widespread approval (and not a little envy). When asked whether the Asian Crisis had enhanced Australia's reputation in Asia, ASIC replied:

> Yes, that would be my instinct from the feedback we get, and certainly the desire for them to come here to learn about how to regulate.[24]

3.30 Dr John Edwards offered the opinion that, in adjusting to the pressures of globalisation, Australia has, in some ways, gained more control over its economic policy position. He gave the example of the interaction between monetary policy and the exchange rate. Adoption of a floating exchange

21 Submission 13, The Treasury, p.70.

22 *The Charter of Budget Honesty Act (1998)*, (Commonwealth).

23 Submission 13, The Treasury, p.70.

24 Evidence, Australian Securities and Investments Commission, 22 March 2000, p.63.

rate had, he said, made the exchange rate susceptible to external pressures but had returned control of interest rates to the Government.[25]

3.31 The Department of Finance and Administration (DOFA) suggested that rather than restricting the government’s ability to make its own decisions, globalisation has had an effect on the consequences of those decisions. Decisions now have a greater impact, positively or negatively, depending on the reaction of global financial markets to the action undertaken. DOFA said that this “increased the importance of transparency and the like”.[26]

3.32 DOFA added that the fiscal reforms undertaken by Australia in recent years have provided a competitive edge in international markets. Any increase in the transparency of fiscal decision making is looked on favourably by global capital markets and, in Australia, “even taxpayers now have a better picture of government expenses and how their moneys are being used”, DOFA said.[27]

3.33 The Committee found that, the indications are that Australia’s policy stance is well regarded by the international financial markets. As tangible proof of this, the Treasury submission reported that in mid-1999 the ratings organisation Standard and Poors upgraded the Commonwealth’s foreign debt issues. The company raised the rating from AA to AA+, the second highest rating, at a time when most of the region was still in financial disarray.[28]

Shared currency

3.34 A number of witnesses raised the question of whether Australia should join in a currency union. It was variously suggested that there could be benefits in associating the Australian dollar with the NZ dollar, or the US dollar, or some regional currency arrangement.

3.35 The Australian Stock Exchange tentatively canvassed the idea that Australia might study the advantages of “dollarisation” i.e. adopting the $US as Australia’s currency. This step is already under consideration by a number of countries in South America. It also suggested that if the idea of

25 Evidence, Dr J. Edwards, 22 March 2000, p.99.
26 Evidence, DOFA, 13 March 2000, p.54.
27 Evidence, DOFA, 13 March 2000, p.54.
28 Submission 13, The Treasury, p.71.

an Asian currency, already being studied by ASEAN, comes into being, then Australia could consider joining that currency union.[29]

3.36 The advantage of such a decision, would be to reduce the incidence of currency crises. The disadvantage is, that to join, Australia would have to surrender its independent monetary policy. If Australia were the smaller country involved – as in joining with the $US – it would require the acceptance of the larger country's monetary policy.[30] It would also mean the loss of the revenue derived from seigniorage[31].

3.37 More importantly, it would mean the loss of a very useful way of dealing with relative price differentials between regions – normally absorbed through variations in the exchange rates. If there is a common currency such differentials must be dealt with instead by a myriad of individual price adjustments. For Australia this would be an important factor in favour of retaining an independent currency.[32]

3.38 When asked about the prospect of an Asian currency, the Reserve Bank indicated that this was unlikely to develop. The Governor of the Bank said:

> I cannot conceive that getting off the ground. The countries are so different and there is no political will behind it anyhow, so I do not think there is any likelihood of that at all. … I would put it in the realms of the highly unlikely.[33]

3.39 The Australian Stock Exchange (ASX) in its evidence, agreed that, although it had canvassed the idea in its submission to the inquiry, it was now unlikely that an Asian currency would eventuate. The exchange supported the Reserve Bank's assessment of the situation.[34]

3.40 The Treasury said there was no hard and fast answer on the question of a shared currency but noted 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

29 Submission 6, Australian Stock Exchange Limited, p.5.

30 Submission 6, Australian Stock Exchange Limited, p.5.

31 Seigniorage is the difference between the production cost of the currency unit and its face value. It is generated when the public exchanges interest-bearing assets for currency. Submission 6, Australian Stock Exchange Limited, p.5.

32 Submission 6, Australian Stock Exchange Limited, p.5.

33 Evidence, Reserve Bank of Australia, 9 February 2000, p.6.

34 Evidence, Australian Stock Exchange, 9 February 2000, p.17.

> criteria in Europe that were designed to achieve economic convergence before economic monetary union commenced. Those conditions were reasonably uncompromising, although I must say … 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.[35]

3.41 One of the main reasons advanced for the concept of a shared currency was to reduce the incidence of contagion between crisis prone countries. The Treasury, however, took different view:

> … 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.[36]

3.42 Treasury's opinion was that different exchange rate regimes might suit different countries at different times. It did not seem necessary, Treasury said, that the regime should be one of the extremes of the spectrum – a floating exchange rate or a completely fixed exchange rate. Treasury was of the opinion other exchange rate regimes can be sustained for long periods of time and that the important thing 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.[37]

3.43 There has also been considerable media speculation recently about the idea of a joint Australian-NZ currency – an ANZAC dollar. This idea was previously raised at one of the Reserve Bank's biannual appearances before this Committee. The Bank's response was that since the costs and benefits of such a change fall to the smaller country involved, Australia is leaving the running on this issue to New Zealand.[38] The Committee is not convinced that Australia would benefit from a regional currency union, however, that would not preclude NZ pegging its currency to the $A.

35 Evidence, The Treasury, 13 March 2000, p.48.

36 Evidence, The Treasury, 13 March 2000, p.48.

37 Evidence, The Treasury, 13 March 2000, p.48.

38 House of Representatives Standing Committee on Economics, Finance and Public Administration, *Review of the Reserve Bank of Australia Annual Report 1998-99*, June 2000, CanPrint Communications, Canberra, p.25 and evidence to that inquiry, Reserve Bank of Australia, 22 May 2000, pp.80-81.

3.44 Nevertheless, there is a need for Australian policy makers to closely monitor the European experience with the introduction of the Euro; the most significant recent example of currency convergence in the world.

Strategies against market volatility

3.45 Market volatility was at the heart of the Asian Crisis. The build-up in several countries of short term speculative capital, unhedged against changes in the market, allowed the massive retreat of overseas funding which drove the crisis.

3.46 The Committee said that it was noticeable that countries where a greater proportion of overseas funding had been in the form of long-term investment in capital projects, for example Malaysia, were less severely affected by the crisis.[39]

3.47 The other weakness which quickly led the crisis countries into difficulty, was the attempt to maintain fixed or partially fixed exchange rates. The Reserve Bank has credited the floating Australian exchange rate with the major role in maintaining Australia's ability to avoid contagion during the crisis.

3.48 To maintain a fixed exchange rate in the conditions leading up to the Asian Crisis required great resolve on the part of central bankers and enormous reserves of foreign exchange. In the end, the worst affected countries proved to have too little of both.

3.49 The importance of sound economic policies in dealing with a volatile market cannot be overstated. Dr Edwards in his evidence, pointed out that at the beginning of the crisis, Australia shared many points of similarity with the crisis countries: a current account deficit of similar size to Korea's, foreign debt of about the same size and maturity as Korea's and a level of foreign reserves lower than Indonesia's. Yet Australia was relatively unscathed while the crisis countries were financially devastated.[40]

3.50 Dr Edwards placed great weight on the benefits derived by the Australian economy from the reforms of the past 15 years:

> The intent of the bulk of those [changes] was to increase our openness to the global economy, and we have benefited hugely

39 Evidence, Dr J.Edwards, 22 March 2000, p.102.

40 Evidence, Dr J. Edwards, 22 March 2000, p.96.

> from those reforms – in particular, tariff cuts, float of the currency and deregulation of financial markets – as much from opening ourselves to the world as from changes we have been able to make internally, such as deregulation of the labour market and improvements to our taxation system.[41]

3.51 The Reserve Bank in its evidence, assigned the greatest importance to the floating exchange rate[42]. However, it also recognised the importance of the structural changes to Australian financial markets in resisting the effects of the Asian Crisis. The RBA suggested that a comprehensive risk management strategy requires great depth in financial markets, to permit the government to avoid reliance on short-term funding and to reduce the impact of sudden changes in the market. Australia, the RBA said, now has that depth and the Government is able to borrow for long periods (10-13 years), in $A, from both Australian citizens and foreign lenders. During the crisis this facility considerably reduced Australia's exposure to currency fluctuations.[43]

3.52 The other key factor in resisting market volatility is the ability to control inflation. Australia has been operating at low levels of inflation now for several years and was able to avoid excessive inflationary pressures during the crisis. If inflation is allowed to push up internal interest rates, it becomes difficult to restrain offshore borrowing – this was the problem faced by a number of the Asian crisis countries. Funds flowed in from low interest rate areas such as the US and Europe, whose investors were only too happy to take advantage of the demand created by the rapid increases in Asian interest rates. Asian borrowers appreciated the access to lower interest rates but were helpless when the flood of funds began to reverse itself.

3.53 Allied to these aspects of the risk management process is the need for the system to be as transparent as possible and for a comprehensive regulatory and prudential system to be in place. With the reforms to these aspects of the Australian system in recent years, Australia is widely regarded as close to world's best practice in each of these crucial areas.[44] Likewise, as previously mentioned, the stability of the democratic government system is of paramount importance.

41 Evidence, Dr J. Edwards, 22 March 2000, p.95.

42 Evidence, Reserve Bank of Australia, 9 February 2000, pp.5-6.

43 Evidence, Reserve Bank of Australia, 9 February 2000, pp.5-6.

44 Submission 13, The Treasury, pp.26-8 & 30.

Electronic commerce and transfer pricing

3.54 Another significant issue is the growth of electronic commerce, especially the difficulty of correctly taxing electronic transactions. In that context discussion centres on the concept of "transfer pricing". In a report in 1998, the Joint Committee of Public Accounts and Audit (JCPAA), quoting from an OECD paper, wrote:

> Transfer prices are significant for both taxpayers and administrations because they determine in large part the income and expenses, and therefore taxable profits, of associated enterprises in different tax jurisdictions.[45]

3.55 Transfer pricing is a form of international tax avoidance. It refers to a practice mainly employed by trans-national companies to shift the main burden of taxation on their profits to the office located in the country with the lowest tax regime. The practice can be effective for related members of a corporate group and for different branches or divisions of the same corporation. At times third party arrangements with unrelated companies are also employed.

3.56 Transfer pricing is applied by the parties agreeing on artificial prices, payments or other terms, to alter the amount of tax which would have been payable if the parties were independent. To counter the practice taxation authorities apply the "arm's length principle", that is to determine the price which would have been paid in the transaction if it had been between independent companies. The aim is simply to ensure that Australia can collect its fair share of the tax due. The JCPAA referred to the methodologies set out in *The Australian Master Tax Guide*:

> There are a number of internationally accepted arm's length methodologies, all of which are based on the concept of comparability – comparing the prices / margins achieved by associated enterprises in their dealings with each other to those achieved by independent enterprises for the same or similar dealings. Taxpayers should utilise the method which produces the highest practicable degree of comparability. The standard of comparability that is practicable will be determined by how much reliable data is available to make comparisons with uncontrolled situations.[46]

45 Joint Committee of Public Accounts and Audit, *Internet Commerce: To buy or not to buy?*, Report 360, AGPS, CanPrint Communications, Canberra, May 1998, p.70.

46 Joint Committee of Public Accounts and Audit, *Internet Commerce: To buy or not to buy?*, Report 360, AGPS, CanPrint Communications, Canberra, May 1998, p.70.

3.57 Treasury said that the Australian Taxation Office (ATO) had been concentrating on reducing the problem in Australia. At the time of the hearing, there were cases under review involving expected tax adjustments of more than $400 million. In one area already audited, the ATO representative reported a 90 per cent increase in reported taxable incomes. He reported that 70 major audits were in progress.[47]

3.58 More generally on e-commerce, the Committee was concerned that the growing use of Internet transactions would make tax assessment more difficult? It asked how could the Taxation Office determine when taxes such as the GST were due and how much was payable? Treasury reported that these were not issues specifically related to e-commerce. The problem had been around for a long time – all that e-commerce changed was the speed and the number of transactions.[48] The JCPAA, however, found that generally, the international community was expecting the problems to grow both in frequency and complexity.[49]

3.59 Treasury noted that when something was purchased over the Internet, there would be a record of the payment – e.g. with one of the credit card organisations – and the Taxation Office has access to those financial records. Treasury reported that there was a considerable amount of work going on in technical working groups of the Organisation for Economic Cooperation and Development (OECD) on these issues and it is hoped that the results of that work will have world-wide application.[50]

3.60 For small transactions, there remained the problem of balancing administrative costs with the revenue to be collected. Customs, for example, has an insubstantial value provision and does not collect import duty on minor purchases where the value of the purchase is insubstantial or where the revenue would not cover the cost of collection ($50 is the benchmark).[51] A similar provision was used to waive any sales tax due.[52]

3.61 Treasury said that there was no suggestion at this stage that existing taxation systems could not cope. In the long-term, however, Treasury expected that national taxation regimes would be backed up by a comprehensive international exchange of information and that there

47 Evidence, The Treasury, 13 April 2000, p.121.

48 Evidence, The Treasury, 13 April 2000, p.125.

49 Joint Committee of Public Accounts and Audit, *Internet Commerce: To buy or not to buy?*, Report 360, AGPS, CanPrint Communications, Canberra, May 1998, pp.70-1.

50 Evidence, The Treasury, 13 April 2000, p.126.

51 Evidence, The Treasury, 13 April 2000, pp.123-5.

52 Joint Committee of Public Accounts and Audit, *Internet Commerce: To buy or not to buy?*, Report 360, AGPS, CanPrint Communications, Canberra, May 1998, pp.110-1.

would be much greater uniformity in taxation rates on both income and consumption. The example was given of the OECD's attempts to have its members jointly identify tax havens and apply penalties to transactions with those places.[53]

3.62 However, given that tax regimes can be used to provide a competitive advantage, e.g. as in recent years in Ireland, the Committee does not share Treasury's expectations regarding uniformity of tax regimes. The Committee recommends that a major study be undertaken to explore the impact of these taxation regimes, particularly in the light of our recent reforms.

Australia as a regional finance centre

3.63 The Committee was interested in the Government's decision to work towards making Australia an international financial centre for the region. It noted that the Minister for Financial Services and Regulation, the Hon Joe Hockey, had enumerated the advantages that Australia has to offer as a financial centre:

- political stability;
- deep and liquid financial markets;
- a strong and growing domestic economy;
- a highly educated, multi-skilled and multi-lingual workforce;
- world class infrastructure;
- a world class regulatory framework; and
- a working day that spans the time zone from the close of business in the US to the opening of business in Europe.[54]

3.64 Mr Hockey also outlined specific programs designed to attract investment in modern, high growth industries. Prominent among these is Invest Australia, a national agency which facilitates major investment projects and provides a range of services to companies establishing operations in Australia. Similarly, the Regional Headquarters Program encourages companies to make Australia their servicing base for the Asia-Pacific region. The program offers tax incentives and offers assistance in other

53 Evidence, The Treasury, 13 April 2000, pp.127-8.

54 Hon Joe Hockey, *Australia as a centre for global financial services*, Speech, New York, 14 July 1999, pp.1-2, 4. http://www.minfsr.treasury.gov.au/speeches/1999/018.asp

areas, such as immigration arrangements for executives of the company. The Minister has also indicated that Australia has an advantage[55]

3.65 In this context, the recent series of decisions to increase interest rates had sparked media speculation that the advantages offered by Australia would be eroded. The Governor of the Reserve Bank refuted suggestions that the interest rate increases would make Australia a less attractive place for the development of a financial centre, and commented:

> I certainly do not agree with that assessment … It seems to me that the thing that we can do directly to make Australia an attractive place for people to do business in is to have a good economic performance and the main test of that would be further long, sustainable economic expansion. The rise in interest rates, we believe, will contribute to that and that is the major thing we can do.[56]

3.66 Raising interest rates to maintain the stability of the system should, the RBA said, be considered sound economic policy:

> Personally, I cannot see a mechanism whereby raising interest rates in a responsible manner, as has been done here and has been done in a number of other countries – major financial centres like the US and the UK – could in any way be construed as being detrimental to their growth as financial centres.[57]

3.67 Referring again to the interest rate increases and whether they would be an issue that might harm Australia's case with investors, the RBA said:

> It certainly is not an issue. In fact, I think that if we had tried to defy gravity, it might have been harmful. But by doing the sensible thing, I do not think it has done any harm at all.[58]

3.68 Dr Carolyn Currie commented that Australia needed to undertake some taxation changes to make itself competitive with cities such as Hong Kong:

> The whole point about Australia as a financial centre is that we want the financial centre to migrate here. For that to happen we have to do a few things, which is equalise our tax with the

55 Hon Joe Hockey, *Australia's Place in the Asian Financial Landscape*, Speech to Credit Suisse First Boston Asian Investment Conference, Hong Kong, 24-26 March 1999, p.5. http://www.minfsr.treasury.gov.au/speeches/1999/009.asp

56 Evidence, Reserve Bank of Australia, 9 February 2000, p.3.

57 Evidence, Reserve Bank of Australia, 9 February 2000, p.3.

58 Evidence, Reserve Bank of Australia, 9 February 2000, p.3.

> regimes, equalise the incentives offered to relocate here and equalise our visa and air fares.[59]

3.69 On this topic of taxation regimes, the Australian Stock Exchange suggested that there are some impediments to the idea of attracting a financial centre to Australia, mainly in the form of taxes. ASX added that recent taxation decisions had improved Australia's competitive position – changes to capital gains tax, a range of State taxes being scheduled for removal and the planned abolition of the stamp duty on share trading on 1 July 2001:

> The whole tax reform push has been a great plus, and the new efforts, with the appointment of Les Hosking as the head of a centre for global financial services, is certainly going to be a very important part of promoting Australia. Getting Australia on the radar is not always easy. … when you are 1.2 per cent of world … capital it is not always easy to get yourself on the radar of the decision-makers.[60]

3.70 Mr Hockey addressed the question of the Australian tax regime in a speech in New York. He explained that Australia's tax reform legislation included a number of features which would enhance Australia's attraction as a financial centre. As examples, he referred to the removal of some inefficient financial services taxes, relaxed taxation provisions for mutual fund investors and an overhaul of Australia's treatment of Offshore Banking Units.[61]

3.71 ASX advised the Committee that scale and volume of business were all important in the global markets:

> One of the reasons we were seeking to merge with the SFE was in fact to have that scale for Australian exchanges to be a more significant player on the world stage. A lot of our efforts will continue to have to go into lifting this scale of Australia's operations.[62]

59 Evidence Dr Carolyn Currie, 9 February 2000, p.31.

60 Evidence, Australian Stock Exchange, 9 February 2000, p.21.

61 Hon Joe Hockey, *Australia as a centre for global financial services*, Speech, New York, 14 July 1999, p.3. http://www.minfsr.treasury.gov.au/speeches/1999/018.asp

62 Evidence, Australian Stock Exchange, 9 February 2000, p.21.

Table 1: Value of Share Trading ($US million)

Country	1998	1999	% Change 1999/98
Australia	161,001	198,195	23.1
Hong Kong	206,153	230,032	11.6
Singapore	58,510	107,407	83.6

Source International Federation of Stock Exchanges, Paris, Table 1.4B http://www.fibv.com/

3.72 The DFAT EAAU noted that the strength of Australia's prudential framework and financial markets enhance its attractiveness as a regional financial centre. The EAAU also commented:

> In 1998, to promote Australia's regional financial centre role and initiate policy reforms to enhance this objective, the Government appointed a Minister for Financial Services and Regulation.[63]

3.73 The Committee observed that when the likely scale of operations for such an international finance centre is considered, it raises a problem that Australia must urgently address; that is ensuring that sufficient specialists are available to fill all of the skilled jobs which would be generated. It has been estimated that a major bank would need five thousand of such specialists to relocate its finance centre to Australia – including IT specialists, lawyers, accountants, etc.

3.74 To offset this difficulty, of course, Australia offers benefits that are not to be found anywhere else in the region – low cost operations, high quality workforce, political stability and quality of life – the Committee added.

3.75 The EAAU summed up Australia's case as follows:

> The Australian economy and financial sectors performed strongly during the financial crisis, partly because over the past two decades, Australia has reformed prudential controls and liberalised its financial market. These moves strengthen Australia's position as a regional and global financial centre, as do skilled, competitively priced financial market human resources. Recent taxation reforms enhance this competitiveness; consequently major foreign financial institutions including Citibank, Deutsche Bank and Hong Kong Shanghai Bank are relocating regional functions to Australia.[64]

63 East Asia Analytical Unit, *Asia's Financial Markets: Capitalising on Reform*, Department of Foreign Affairs and Trade, Canberra, 1999, p.344.

64 East Asia Analytical Unit, *Asia's Financial Markets: Capitalising on Reform*, Department of Foreign Affairs and Trade, Canberra, 1999, p.12.

Recommendation 2

3.76 **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;**
- **continue to explain what steps are being taken to reduce Australia's current account deficit;**
- **carry out additional work on public discussion and the dissemination of information on the changes occurring in international financial markets;**
- **determine whether additional measures are required to ensure that Australia does not experience a build-up of short-term foreign debt; and**
- **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.**

Recommendation 3

3.77 **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.**

4

Transparency and information requirements

4.1 As globalisation progresses, the need for the application of international standards and cooperation in addressing problems grows. In this context, international conferences have identified the need for greater transparency and accountability in the financial system as an area of prime importance. The terms transparency and accountability have been taken by the Committee to mean:

> … improving the range, relevance, reliability, comparability and understandability of information – information generated by governments and all market participants – and how that information is used by the various players in pursuing their individual objectives.[1]

4.2 The Federal Treasurer in his opening remarks to the Manila Framework Group in March 1999, nominated improvement in transparency as a key element in improving the global financial system. The Managing Director of the IMF, Michael Camdessus, gave it even greater prominence, when he said that greater transparency in international finance held the key to world economic stability.[2]

4.3 Governor Roger Ferguson of the US Federal Reserve Board expressed similar views:

> … we should seek ways of improving the transparency of financial institutions and markets. As we all know, full information is a fundamental requirement of free and competitive markets. More particularly, financial institutions and individual investors must be well informed about their own and their counterparties' exposures, the nature of new financial instruments, and the extent

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1 The Treasury, *Making Transparency Transparent: An Australian Assessment*, AGPS, CanPrint Communications, Canberra, March 1999, p.iii.

2 Submission 13, The Treasury, p 35.

> of overall market liquidity. I believe that banks and other financial institutions could significantly improve their disclosures by providing more information to the market about their risk management policies and practices and about the values of internal risk measures.
>
> … One of the key lessons of our most recent financial crisis is that international accounting and public disclosure standards are often inadequate. … Much more … should be done to provide the public and supervisors with the information they need to exert effective market discipline.[3]

4.4 The Australian Stock Exchange expressed the idea very simply: "… information is critical to the function of international financial markets. As a result market participants have a vested interest in privately pursuing information."[4]

4.5 An important step in improving the transparency of the world financial system occurred in November 1998, when the Basle Committee on Banking Supervision of the Bank for International Settlements, released a paper entitled "Core Principles for Effective Banking Supervision". This paper was a revised version of a document released for international public discussion in April 1997. It set out twenty-five basic Principles which the Basle Committee believed to be essential for a supervisory system to be effective.

4.6 A number of these principles bear directly on the need for supervisors to have access to all necessary information to determine the soundness of a bank's financial situation. In particular, the principle on Information Requirements states:

> Banking supervisors must be satisfied that each bank maintains adequate records drawn up in accordance with consistent accounting policies and practices that enable the supervisor to obtain a true and fair view of the financial condition of the bank and the profitability of its business, and that the bank publishes on a regular basis financial statements that fairly reflect its condition.[5]

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3 Governor Roger W. Ferguson, Jr., Federal Reserve Board, *Evolution of Financial Institutions and Markets: Private and Policy Implications*, Remarks at the Money Marketeers of New York University, New York, 25 February 1999, pp 1-2. http://www.bog.frb.fed.us/BOARDDOCS/SPEECHES/1999/199902252.htm

4 Submission 6, The Australian Stock Exchange, p.6.

5 *Basle Core Principles for Effective Banking Supervision*, Press Statement of the Basle Committee on Banking Supervision of the Bank for International Settlements, reproduced in Economic Perspectives, USIA Electronic Journal, Vol.3, No.4, August 1998, p.4. http://www.usia.gov/journals/ites/0898/ijee/ejfaf2.htm

4.7 Dr John Edwards in his evidence to the Committee, sounded a warning note about the continuing trend towards demanding greater transparency. He said that the downside is that people expect more from transparency than it is able to deliver:

> … We had the example of Brazil and Argentina in 1998 which really could not have been more transparent about their monetary and fiscal policies or the daily state of their reserves, and this merely signalled to the market how desperate things were becoming. … after the Tequila crisis the IMF promulgated new standards for disclosure and transparency which, just prior to the Asia crisis the deputy director, Mr Fisher then stated … had been widely accepted, yet that whole sequence of events occurred nonetheless. **I think the real problem with transparency is that people expect too much of it** [emphasis added].[6]

Australia's self assessment

4.8 In October 1998, to encourage other countries to carefully examine their performance in this area, Australia undertook to produce a self-assessment of the transparency of its own financial system as a model for others to follow. The Treasury in the introduction to the study, indicated that its intent was to examine Australia's adherence to international disclosure standards and also to various other sound practice principles (whether legal or voluntary).[7]

4.9 The report arising from this self-assessment process was entitled *Making Transparency Transparent*. The report highlighted the advantages to be gained from greater transparency:

> Improved transparency contributes to a more efficient allocation of resources by: ensuring market participants have sufficient information to identify risks; informing market expectations; contributing to the effectiveness of announced policies; and ultimately enhancing the stability of financial markets by assisting in the prevention of a build up of financial and economic imbalances.[8]

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6 Evidence, Dr J. Edwards, 22 March 2000, p.105.

7 The Treasury, *Making Transparency Transparent: An Australian Assessment*, AGPS, CanPrint Communications, Canberra, March 1999, p.vi.

8 The Treasury, *Making Transparency Transparent: An Australian Assessment*, AGPS, CanPrint Communications, Canberra, March 1999, p.v.

4.10 The report commented that the better the quality of the information available, the better equipped governments and market participants are to make sound policy decisions. In turn, soundly based policies and operating decisions make economies less vulnerable to shocks, panics and imbalances. These conditions are needed across the whole range of government and private economic activities.[9]

4.11 To reach its findings, the report compared Australia's practices to those recommended by international codes – in some areas, codes and standards already operating; in others, codes being drafted by international organisations. In the important fiscal and monetary policy sectors, Australia's practice was compared to the IMF's draft *Code of Good Practices on Transparency in Monetary and Financial Policies*.[10]

4.12 Australia's fiscal framework was found to be consistent with the principal features of the Code and monetary policy arrangements were found to compare favourably with the Code's principles of sound practice. In other areas, such as accounting standards, corporate governance and financial sector supervision, the report also noted that Australia's arrangements are consistent with the appropriate international standards.[11]

4.13 When asked by the Committee about the IMF code, the Governor of the Reserve Bank described the provisions as "very sensible". He added that "… we meet these requirements without any trouble."[12]

4.14 Commenting on its report *Making Transparency Transparent*, Treasury said:

> The report … benchmarks Australia's practices against a wide array of 'best practice' international standards and gives an example of how economies can explain their economic policies and institutional arrangements. Ensuring that such policies are comprehensively understood in the global marketplace establishes credibility and … allows investors to make a more informed risk assessment. This not only promotes market efficiency, but may also reduce the risk of 'contagion', at a time of crisis, as lenders are able to distinguish between the financial circumstances facing different countries.[13]

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9 The Treasury, *Making Transparency Transparent: An Australian Assessment*, AGPS, CanPrint Communications, Canberra, March 1999, p.iii.

10 The Treasury, *Making Transparency Transparent: An Australian Assessment*, AGPS, CanPrint Communications, Canberra, March 1999, pp.viii-x.

11 The Treasury, *Making Transparency Transparent: An Australian Assessment*, AGPS, CanPrint Communications, Canberra, March 1999, pp.3-7.

12 Evidence, Reserve Bank of Australia, 9 February 2000, p.11.

13 Submission 13, The Treasury, p 36.

4.15 The issues examined included the way in which information is created, how it is collated and published and the codes and standards guiding public and private use of the information.[14] The idea for the project arose from a G22[15] recommendation that the IMF prepare transparency reports for each country, summarising the degree to which an economy meets internationally recognised disclosure standards.[16]

4.16 The report makes it clear, however, that the views expressed are not necessarily those of the Australian Government and that it simply represents a stock-take of Australia's performance against international standards. Some of the standards themselves are still under development and the report is therefore regarded as a "work-in-progress", which will develop and change over time.[17]

4.17 Since the Australian assessment was produced, the staff of the IMF have carried out a number of assessments in other countries, including the UK. Australia's Treasury suggested that that process would accelerate and, in fact, an assessment of a country's observance of accepted codes and standards, could become a standard part of Article IV consultations. Treasury remarked that "it is a transparency that is becoming increasingly valued … because the international financial community is wanting this information" and concluded:"… it is increasingly being seen as being in countries' own interests to provide the information."[18]

International opinion

4.18 In the US, the President's Working Group on Financial Markets provided additional support for international proposals to improve transparency and the quality of information made available to market participants. The Working Group report commented:

> Improving transparency through enhanced disclosure to the public should help market participants make better, more

14 The Treasury, *Making Transparency Transparent, An Australian Assessment,* AGPS, CanPrint Publications, Canberra, March 1999, Preface, p.iii.

15 G22 membership see footnote 56, Chapter 2.

16 Task Force on International Financial Reform, *Report to the Prime Minister,* AGPS, CanPrint Communications, Canberra, 1998, p.49.

17 Task Force on International Financial Reform, *Report to the Prime Minister,* AGPS, CanPrint Communications, Canberra, 1998, p.vii.

18 Evidence, The Treasury, 13 March 2000, p.41.

> informed judgements about market integrity and the creditworthiness of borrowers and counterparties.[19]

4.19 The IMF, in its annual assessment of international capital markets in September 1999, observed that gaps in the available information on financial products had been a problem area during the Asian Financial Crisis. The report suggested that, while considerable attention is being paid to this failing, official proposals for increased disclosure and transparency have not clearly indicated what type of additional information should be supplied, how often or to whom (investors, depositors, shareholders, counterparties or supervisors).[20]

4.20 The IMF considered that more time is needed to fully understand how the changes in modern financial systems have altered the information requirements necessary for efficiently handling risk factors. More information is needed about risk exposures, off-balance-sheet activities and over-the-counter derivatives markets.[21]

4.21 On balance, however, the Fund concluded that:

> … More information would improve the ability of financial institutions to strengthen quantitative and qualitative tools for managing financial risk. Better and more timely public disclosure of appropriate information … could potentially improve the ability of private stakeholders to assess risks and act accordingly in pricing risk and allocating portfolios. Likewise, the ability of supervisors and those responsible for surveillance to exercise adequate oversight could also be improved, with more accurate and comprehensive information …
>
> … To know what information is required requires analytical frameworks capable of understanding, assessing, and monitoring modern finance. … There are no simple solutions to analytical problems … supervisors also require new tools and techniques and better and more comprehensive information … for examining individual institutions. …[22]

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19 *Hedge Funds, Leverage, and the Lessons of Long-Term Capital Management*, Report of the President's Working Group on Financial Markets, Washington D.C., April 1999, p.32.

20 International Monetary Fund, *International Capital Markets: Developments, Prospects, and Key Policy Issues*, World Economic and Financial Surveys, Washington D.C., September 1999, p.142. http://www.imf.org/external/pubs/ft/icm/1999/index.htm

21 International Monetary Fund, *International Capital Markets: Developments, Prospects, and Key Policy Issues*, World Economic and Financial Surveys, Washington D.C., September 1999, p.142. http://www.imf.org/external/pubs/ft/icm/1999/index.htm

22 International Monetary Fund, *International Capital Markets: Developments, Prospects, and Key Policy Issues*, World Economic and Financial Surveys, Washington D.C., September 1999, p.149. http://www.imf.org/external/pubs/ft/icm/1999/index.htm

4.22 Treasury agreed that greater transparency would improve risk management:

> 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, …[23]

4.23 The other advantage produced by greater transparency, according to Treasury's evidence, is that it reduces the opportunities for market manipulation:

> 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.[24]

4.24 Treasury did warn, however, that greater transparency alone would not stop financial crises. There was a need, Treasury said, to integrate the principles of transparency into market assessments, not merely to improve the quality of the data. The example was used of the failure of ratings agencies to downgrade the debt of the Asian Crisis countries – demonstrating weaknesses in the system of assessing available data.[25] The Committee concluded that improving the data would not have solved this problem. **Important though it is, transparency is not a forecasting system and, at the end of the day, unexpected shocks can still produce adverse reactions.**

Disclosure by private market participants

4.25 In academic circles the Committee found that there has been a tendency to dispute the need for transparency to be imposed by the application of mandatory standards. The argument is, that the needed level of fair and efficient operation of markets will be achieved by market pressures and

23 Evidence, The Treasury, 13 March 2000, p.35.

24 Evidence, The Treasury, 13 March 2000, p.39.

25 Submission 13, The Treasury, pp.36-7.

the need for firms to attract investors. The Treasury noted, however, that Australia's view is that to both attract investors and maintain their confidence in market integrity, full public disclosure of information is essential. It added that this philosophy is in line with the OECD's corporate governance framework. The underlying principle of that framework is that the system:

> … should ensure timely and accurate disclosure of information on all material matters regarding the financial situation, performance, ownership and governance of companies.[26]

4.26 The SFX warned that there were some difficulties involved in insisting on greater transparency from public companies. The data available is usually in the form of a "snapshot" of the firm's situation, usually on an annual or quarterly basis. The further you are from the date of this "snapshot", the less reliable it is regarding the companies current financial exposure. The other area of difficulty, is that of framing disclosure obligations so as to avoid requiring a company to release proprietary information to competitors.[27]

4.27 The SFX suggested that the latter problem would restrict counter-parties to requesting:

- broad concentrations of data, e.g. based on countries or types of product;
- availability of liquid unsecured assets; and
- assumptions employed to calculate the value at risk; the types of stress tests performed and other indicators of risk management capabilities.[28]

4.28 The Treasury rated the role of the private sector in dealing with financial crises as the most complex of the issues being considered internationally. Treasury referred to the work of a G22 Working Group on Transparency and Accountability and noted its finding that there was an absence of principles and standards internationally, to guide disclosure practices.[29]

4.29 The main aim of seeking greater transparency in the financial sector is to permit a much higher standard of risk management among market participants. It is widely believed that the lack of proper understanding of the risk levels involved in some investments has been a contributing cause of difficulties, not only in the Asian Crisis but in many of the financial crises of recent years. The Reserve Bank reported that this situation even applied to major banks:

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26 The Treasury, *Making Transparency Transparent: An Australian Assessment*, AGPS, CanPrint Communications, Canberra, March 1999, pp.21-2.

27 Submission 9, Sydney Futures Exchange, p.6.

28 Submission 9, Sydney Futures Exchange, p.6.

29 Submission 13, The Treasury, p.38.

> One of the biggest problems was that the people who were lending did not even know what they were doing. The people who were lending did not know the risks they were taking and that is a very severe shortcoming of a financial market, to have respectable prestigious banks lending to small, incredibly risky hedge funds and not knowing how big the risks were they were taking. The new approach to hedge funds is to cut off that supply of credit –a sort of unthinking supply of credit – by various rules on disclosure.[30]

4.30 The Bank for International Settlements formed a Working Group to examine transparency in the operations of individual market participants. The Group recommended: "that all financial institutions be encouraged to make available to clients and lenders a greater range of information on their risk profile."[31]

4.31 Australia has given a high priority to improving transparency in the financial system. An illustrative example is the approach to disclosure requirements in the CLERP6[32] legislation. A consultative paper on the implementation of CLERP6 included these comments:

> Disclosure regulation is the core of any regulatory scheme to protect consumers as it enhances consumers' ability to assess financial products and make informed decisions. Effective disclosure obligations must promote the production and provision of relevant and useful information at the point of sale of a financial product which consumers can effectively use to assess the features of a product and decide whether a product meets their needs. Currently, participants in Australia's financial markets face a range of information disclosure rules which vary greatly in their status, degree of prescription and penalties for breach.[33]

4.32 The paper also noted that submissions on CLERP6 had been supportive of harmonised and consistent disclosure obligations, with the flexibility to apply to a range of financial products. An important proviso is that product users and/or directors are to be held criminally and civilly liable

30 Evidence, Reserve Bank of Australia, 9 February 2000, p.7.

31 Submission 7, Reserve Bank of Australia, p.7.

32 CLERP6: The Treasury, *Financial Markets and Investment Products: Promoting competition, financial innovation and investment*, Corporate Law Economic Reform Program Proposals for Reform Paper No.6, AGPS, CanPrint Communications Pty Limited, 1997.

33 The Treasury, *Financial Products, Service Providers and Markets, Implementing CLERP6 –* Consultation Paper, as at 27 May 1999, Chapter 4, p.1. http://www.treasury.gov.au/publications/bills%2Cactandlegislation/corporatelaweconomicreformprogram/cle.../chap4.ht

for misleading and deceptive information included in a Financial Product Information Statement.[34]

4.33 ASIC in its submission summarised the effect of this legislation:

> Under current proposals in [CLERP6], an integrated regulatory framework for financial products and markets would be introduced … This regime would apply to virtually all existing financial products including securities, futures and other derivatives, and foreign exchange.[35]

4.34 In evidence to the Committee, ASIC commented that the CLERP6 legislation would remove some of the disparities in disclosure requirements in Australia. The provisions of CLERP6, for example, correct the anomalous situation that, for a product defined as a security, a prospectus must be issued, carrying with it specific disclosure obligations. For futures contracts or similar products, however, there is only a generic requirement for disclosure of the fact that the product carries a risk. ASIC said that CLERP6 imposes a much more uniform disclosure requirement.[36]

Information provided by governments

4.35 The Department of Finance and Administration (DOFA), in its submission to the inquiry, expressed the opinion that the provision of comprehensive information on fiscal policy and the financial standing of the public sector tended to enhance government credibility. This had the additional effect DOFA said, of reinforcing government efforts to improve fiscal balances, because the private sector can see and understand the aims of the government's policies.[37]

4.36 DOFA added that improving transparency is a vital element in crisis prevention – it allows governments to quickly identify emerging policy issues or institutional weaknesses and undertake the necessary corrective action. If the public can see these process at work there is a flow on of confidence to the private sector:

> Greater information will give investors more confidence in the underlying financial soundness of government securities and

34 The Treasury, *Financial Products, Service Providers and Markets, Implementing CLERP6 –* Consultation Paper, as at 27 May 1999, Chapter 4, pp.1 & 6. http://www.treasury.gov.au/publications/bills%2Cactandlegislation/corporatelaweconomicreformprogram/cle.../chap4.ht

35 Submission 8, Australian Securities and Investments Commission, p.2.

36 Evidence, Australian Securities and Investments Commission, 22 March 2000, p.65.

37 Submission No. 12, Department of Finance and Administration, p.3.

> reduce the incentive to dump these securities when global financial insecurity flares. In this way transparency also benefits governments in the form of lower borrowing costs (through lower risk premia) and larger and more stable flows of portfolio and direct investment.[38]

4.37 There was some discussion with the Reserve Bank about the transparency of its control of monetary policy. The response by the Bank to questions posed by the Committee, was that considerable effort is being expended to make the Bank's operations as transparent as possible:

> I think we have made a major effort. We take it seriously. We think that the trilogy of independence, accountability and transparency go together.[39]

4.38 The Governor also referred to the Bank's biannual meetings with this Committee as "a very important contribution to the transparency of the Reserve Bank". He remarked that he made far more public speeches than his predecessors had done but that the optimum in transparency might not necessarily be the absolute maximum. To support this comment, he referred to the situation of the Chairman of the US Federal Reserve – saying that armies of people interpret every word Mr Greenspan says and compare each speech with comments made sometimes years before. He concluded:

> … people interpret his words with such detail that any slight change in a word between two speeches is interpreted as meaning something for monetary policy and it makes it very difficult for [Mr Greenspan]. I do not think we have reached that stage but there is an optimal amount of transparency and probably in the US, through no fault of their own, media attention has taken it beyond that optimum.[40]

4.39 The Committee asked whether the damage caused by speculation prior to Reserve Bank Board decisions on interest rates, could be minimised by publishing the minutes of the Board meetings. The Governor said that speculation was simply something the Bank had to live with – no hint of the decision could be given until the Board actually endorsed it. He said that publishing the minutes would not help because, necessarily, it would be after the event.[41]

38 Submission No. 12, Department of Finance and Administration, p.3.

39 Evidence, Reserve Bank of Australia, 9 February 2000, p.11.

40 Evidence, Reserve Bank of Australia, 9 February 2000, p.11.

41 Evidence, Reserve bank of Australia, 9 February 2000, p.10.

4.40 The aim in introducing recognised world standards on transparency is to overcome some of the regular causes of financial crises – the lack of accurate information about financial markets and the actions of participants. The difficulties which can be caused by a lack of information on financial matters, are best illustrated by an example: A former president of the Korea Economic Institute in the US, commented that when Korea asked the IMF for help in the recent crisis, one of the main difficulties was establishing the extent of the problem. How much short term debt would fall due in the next year? No one knew![42]

4.41 The backlash from this position saw Koreans unwilling to hold their own currency and a consequent slide in the value of the won. This was accompanied by rising import prices, higher interest rates, business and bank failures and growing unemployment.

4.42 The Committee noted that this illustration helps to explain why so much international attention has recently been directed to the question of transparency and the quality of information made available on financial matters. The author's final comment on the Korean example makes the point clear:

> The lack of reliable basic data on the national economy has produced similar results in all of the Asian economies now having difficulties. But this is not new. A lack of information led to the crisis in Mexico in 1994 and to innumerable previous crises. Financial crises regularly occurred in market economies, but just infrequently enough for people to forget.[43]

The availability of data

4.43 The example shown above, also illustrates the problem which arises when governments themselves are unable to access accurate information on the state of their financial system. It underlines the need for countries to provide the IFIs with comprehensive and reliable data. Without solid data to work with, it is impossible for the IMF, for example, to achieve proper supervision of the international financial system.

4.44 The Basle Committee on Banking Supervision, in its report on Enhancing Bank Transparency, noted:

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42 John T. Bennett, *Increasing Financial Transparency in a Global Economy*, USIA, Economic Perspectives, August 1998, p.1. http://www.usia.gov.journals/ites/0898/ijee/ejbenne.htm

43 John T. Bennett, *Increasing Financial Transparency in a Global Economy*, USIA, Economic Perspectives, August 1998, p.1.

> … markets contain disciplinary mechanisms that can reinforce the efforts of supervisors by rewarding banks that manage risk effectively and penalising those whose risk management is inept or imprudent. Market discipline, however, can only work if market participants have access to timely and reliable information which enable them to assess a bank's activities and the risks inherent in those activities. Improved public disclosure strengthens market participants' ability to encourage safe and sound banking practices.
>
> The complementary interaction of prudential supervision and market discipline is critical to promoting long-term stability of both individual institutions and banking systems. The effectiveness of the interaction depends greatly on meaningful public disclosure. This document recommends that supervisors focus their efforts on encouraging high-quality public disclosure at reasonable cost. …[44]

4.45 The report then set out six broad categories of information which should be addressed. Although the report is directed particularly at the banking industry, if the information set out in those categories were to be generally available, the transparency and "user friendliness" of the entire financial system would be improved:

> … It has identified the following six broad categories of information, each of which should be addressed in clear terms and appropriate detail to help achieve a satisfactory level of bank transparency:
>
> - financial performance;
> - financial position (including capital solvency and liquidity);
> - risk management strategies;
> - risk exposures (including credit risk, market risk, liquidity risk, and operational, legal and other risks);
> - accounting policies; and
> - basic business, management and corporate governance information.[45]

4.46 The Bank for International Settlements (BIS) established a Working Group to determine what aggregate data could be collected to improve the efficiency of international markets. The Group decided that efforts should be concentrated on the foreign exchange market – seen as the market of

44 Basle Committee on Banking Supervision, Report No.41, *Enhancing Bank Transparency*, Bank for International Settlements, Basle, September 1998, p.17. http://www.bis.org/publ/bcbs41.htm

45 Basle Committee on Banking Supervision, Report No.41, *Enhancing Bank Transparency*, Bank for International Settlements, Basle, September 1998, p.17. http://www.bis.org/publ/bcbs41.htm

greatest interest and where the data is easier to collect. The Group recommended that there should be more frequent data on market turnover and the positions of major financial participants. It also recommended the enhancement of data on credit exposures.[46]

International standards

4.47 The IMF, in cooperation with other international organisations, has been active in setting out benchmarking standards. The Fund actively encourages its member countries to aim for those benchmarks as minimum standards.

4.48 The benchmark used to measure the transparency of monetary and financial policies is the IMF *Code of Good Practices on Transparency in Monetary and Financial Policies: Declaration of Principles,* released on 16 April 1999. Earlier, a similar standard was set for fiscal policy in the *Code of Good Practices on Fiscal Transparency – Declaration on Principles.* For statistical data the ruling standard is the IMF's *Special Data Dissemination Standard* and for banking, the Basle Committee on Banking Supervision's *Core Principles for Effective Banking Supervision*.

4.49 The Treasury submission, however, noted that it was not enough to simply set the standards; there has to be an awareness among market participants and a willingness to use the available data to rigorously assess the level of risk in transactions:

> … transparency alone will not solve or forestall financial crises. Improving the availability of data is an important step, but if the risk of financial instability is to be reduced, transparency must be taken a step further and integrated into an assessment of the market. The failure of external ratings agencies to downgrade the debt of many of the East Asian crisis countries until after the onset of the crisis demonstrates a weakness on the part of some private participants to adequately assess available information. …[47]

4.50 Treasury commented that there are three main objectives in the development and implementation of international codes and standards:

- first, to serve as a benchmark for economic performance;
- second, to allow the dissemination of relevant, accurate and timely information by governments, institutions and the financial sector; and

46 Submission 7, Reserve Bank of Australia, pp.7-8.

47 Submission 13, The Treasury, pp.36-37.

- third, to facilitate the comparability of data – allowing informed comparisons of the financial and economic performance of firms and economies.[48]

4.51 The Report *Making Transparency Transparent* sets out in its introductory pages, details of a wide range of standards additional to those listed above. These represent standardised codes of conduct, which have either been developed or are being drafted by international organisations. The benchmarks cover topics as diverse as international accounting and auditing standards, corporate governance, regulation of the insurance industry, securities regulation and the treatment of foreign controlled enterprises. The Report reveals that Australia maintains a high level of compliance with all of these standards.[49]

4.52 The Treasury stressed, however, that observance of international standards needs to be a voluntary process and such requirements could not be forced upon an individual country by an outside authority:

> … countries need to be willing to sign up to regulation or 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 for a …[50]

Conclusion

4.53 The Committee found that Australia is already playing a substantial role in international efforts to improve the transparency and accountability of the financial system.

4.54 It also found that Australia already has a high level of compliance with the standards being recommended by international agencies and committees. However, the Committee noted that, important as this is, it should be seen as an aid to, not a substitute for, sound economic practice in both the public and private sectors.

48 Submission 13, The Treasury, pp. 39.

49 The Treasury, *Making Transparency Transparent: An Australian Assessment*, AGPS, CanPrint Communications, Canberra, March 1999, Structure of the Report, pp. viii-x.

50 Evidence, The Treasury, 13 March 2000, p.41.

Recommendation 4

4.55 **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.**

5

International financial architecture

5.1 The Asian Financial Crisis and international consideration of its effects have sparked a complete review of the organisational arrangements controlling the international movement of funds, the so-called International Financial Architecture. Examination of these arrangements is not new. Since the beginning of the collapse of the Bretton Woods system in 1971, world financial arrangements and the roles of IFIs have been under virtually constant scrutiny and criticism.[1]

5.2 Following the Mexican crisis in 1994-5, the present phase of review began with the launch by the IMF of its Special Data Dissemination Standard (SDDS). The SDDS specifies basic criteria for economic and financial data provided to the IMF, for later dissemination on its web-site. A General Data Dissemination System was also established, to assist countries to establish and organise the collection and publication of their data.[2]

5.3 The onset of the Asian Crisis in 1997-98, led to an intensified examination of the International Financial Architecture. The Group of Seven (G7) major industrial countries[3] led the call for improvements. The G7 at their summit in May 1998, instructed their Finance Ministers to work towards an improved international financial architecture by developing new approaches. Four key areas were highlighted for attention:

- increasing the transparency of countries' data and economic conditions;
- helping countries prepare for global capital flows;
- strengthening national financial systems; and

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1 Barry Eichengreen, *Globalizing Capital, A History of the International Monetary System*, Princeton University Press, New Jersey, 1996, p.123.

2 John T.Bennett, *Increasing Financial Transparency in a Global Economy*, Economic Perspectives, USIA Electronic Journals, Vol.3, No.4, 1998, p.1 http://www.usia.gov/journals/ites/0898/ijee/ejbenne.htm

3 G-7 membership is: the USA, Germany, the UK, Japan, France, Canada and Italy.

- ensuring that the private sector takes responsibility for its decisions when crises strike.[4]

5.4 The DFAT EAAU has concluded that one of the lessons to be learned from the Asian Crisis, was the value of a strong international financial infrastructure. Its report on Asian Financial Markets highlighted five key issues to be addressed in the process of reforming the International Financial Architecture:

- improving transparency, by increasing compliance with domestic disclosure rules and cross-border information exchange agreements;
- reducing the potential of highly leveraged institutions like hedge funds to destabilise domestic and international markets;
- tightening and enforcing prudential standards in offshore financial centres;
- reducing capital flow volatility by encouraging more stable capital flows; and
- facilitating greater private sector involvement in crisis prevention and resolution.[5]

5.5 The Committee notes that, although these are worthy goals, no-one should pretend that they will be easy to address in a comprehensive fashion.

5.6 One of these issues, volatile capital flows, was a particular problem during the Asian crisis. It became apparent that speculators were able to move funds into, and out of, capital markets, far faster than the counter-measures available to either domestic markets or the international finance market, could respond.[6] Recognition of this problem and concern over the activities of the speculators and the performance of IFIs in the face of the crisis, increased the pressure on monetary authorities to carefully examine the International Financial Architecture and to re-assess the effectiveness of the systems and organisations currently in place.

5.7 The ASX submission commented that speculation has its place in facilitating the flow of new information but that the speed of financial transactions makes it imperative that economic policies are soundly based. The ASX notes that:

> The speed and magnitude of asset allocation decisions is increasing rapidly, which places much greater pressure on

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4 Economic Perspectives, *Reforming the Global Financial Architecture*, Electronic Journals of the US Information Agency, Vol.3, No.4, August 1998. http://www.usia.gov/journals/ites/0898/ijee/ijee0898.htm

5 East Asia Analytical Unit, Department of Foreign Affairs and Trade, *Asia's Financial Markets: Capitalising on Reform*, Canberra, 1999, p.34.

6 Jack Boorman, Director, IMF Policy Development & Review Department, *The World Financial System Must Act to Prevent Crises*, 28 June 1999 in the International Herald Tribune, p.1. http://www.imf.org/external/np/vc/1999/062899.HTM

> national governments to implement policies based on sound economic principles. No crisis arises from the vast majority of financial transactions, which suggests that governments in most countries make well founded decisions.[7]

Present structure

5.8 The two key organisations in the present structure of the International Financial Architecture are the IMF and the World Bank Group. These organisations are now more than fifty years old and still operating under the original charters established under the Bretton Woods agreement in the aftermath of World War 2. This fact alone has prompted calls for reassessment of their roles and modernisation of the charters under which they operate.[8]

5.9 The World Bank (officially the International Bank for Reconstruction and Development) was designed to channel funds from world capital markets to assist the recovery of Europe and the economic development of developing countries. Joseph Stiglitz, of the World Bank described its role as a development institution, with a focus: "on project lending and structural reforms that enhance long-run development and poverty alleviation."[9]

5.10 The IMF was originally intended to be the world's central bank:

> The IMF was to have been given sufficient resources to influence the global monetary system, issue its own reserve currency and create international reserves as necessary. The gap between that vision and reality widened over the years.[10]

5.11 The Fund's role is now seen as more of a watchdog. It has a mandate to safeguard the soundness and stability of the international monetary system. To achieve this, it undertakes compulsory annual economic policy consultations with each of its member governments. These discussions, known as Article IV consultations, cover a wide range of policy issues and try to address current problems and anticipate future

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7 Submission No.6, Australian Stock Exchange Ltd, p.2.

8 Financial Stability Forum, *Report of the Working Group on Highly Leveraged Institutions*, 5 April 2000, p.12. http://www.fsforum.org/Reports/RepHLI.html

9 Joseph Stiglitz, Senior Vice President and Chief Economist for The World Bank, *The Role of International Financial Institutions in the Current Global Economy*, Address to the Chicago Council on Foreign Relations, 27 February 1998, p.9. http://www.worldbank.org/html/extdr/extme/jssp022798.htm

10 Wendy Dobson, *What To Do With The IMF?*, in Policy Options, July/August 1999, p.37.

difficulties. In addition, of course, the IMF is the front line of defence when financial crises do occur.

5.12 The US Congressional Record described the IMF as:

> … a cooperative institution that 182 countries have voluntarily joined because they see the advantage of consulting with one another to maintain a stable system of buying and selling their currencies so that payments in foreign money can take place between countries smoothly and without delay.[11]

5.13 Stanley Fischer of the IMF summarised the Fund's primary purposes as follows:

- to facilitate … the balanced growth of international trade, and to contribute thereby to … high levels of growth and real income;
- to promote exchange rate stability, to maintain orderly exchange arrangements among members, and to avoid competitive exchange depreciation; and
- to provide members with opportunities to correct maladjustments in their balance of payments, without resorting to measures destructive of national or international prosperity.[12]

Reforming the system

5.14 Efforts to reform international arrangements are widespread and involve committees from a number of international organisations. Prominent among the committees working on the review of international financial arrangements, are the Basle Committee on Banking Supervision and the Technical Committee of the International Organization of Securities Commissions (IOSCO). The BIS in Switzerland, the World Bank and the IMF are all involved in the international committees. The United States, in addition to its involvement in the international efforts, has established a Presidential Working Group on Financial Markets. The OECD in Paris, is also very active in these deliberations and the research underlying them.

5.15 Australia has been prominent in these efforts through participation in international forums; a report from a 'Task Force on International Financial Reform' to the Prime Minister; and also a 'self-assessment' report on Australia's standards of transparency and disclosure (which was

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11 Congressional Digest, *Overview of the IMF: Origin, Organization, and Functions*, Vol.77, No.4, April 1998, p.100.

12 Stanley Fischer, First Deputy Managing Director of the IMF, *The Asian Crisis : A View from the IMF*, Address to the Bankers' Association for Foreign Trade, Washington, D.C., 22 January 1998, p.1. http://www.usia.gov/regional/ea/asiafin/fischr22.htm

intended to encourage similar assessments by other IMF members)[13]. Australia's efforts have also extended to more direct means, through participation in financial support arrangements and the provision of technical assistance.[14]

5.16 The Managing Director of the IMF indicated that, in general terms, international efforts are seeking to:

- promote transparency and accountability, and to develop, disseminate and monitor implementation of better standards and best practices;
- strengthen financial systems, including through better supervision and appropriate mechanisms for managing bank failures;
- pay greater attention to the orderly liberalisation of capital markets;
- involve the private sector more fully in forestalling and resolving crises; and
- ensure that systemic issues are adequately addressed, including the appropriate exchange rate regimes and the adequacy of the [IMF's] resources.[15]

5.17 He commented that success would depend on advancing all of these features together and that a high level of cooperation between the government and private sectors would be essential:

> All of these aspects of a strengthened financial architecture are inter-related. The development, dissemination and monitoring of standards is crucial to the strengthening of financial systems; the choice of exchange rate regime and the strengthening of supervisory systems are an integral part of ensuring an orderly process of capital account liberalisation; better data, greater transparency of countries' policies and the Fund's assessment of them, as well as strengthened financial systems are critical to reducing the volatility of private sector flows.[16]

5.18 The Managing Director stressed that the private sector, national governments and international institutions and forums all need to work together in this endeavour. Private financial institutions must adhere to

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13 The Treasury, *Making Transparency Transparent: An Australian Assessment*, AGPS, CanPrint Communications, Canberra, March 1999.

14 Task Force on International Financial Reform, *Report to the Prime Minister*, AGPS, CanPrint Communications, Canberra, 1998, p.3.

15 International Monetary Fund, *Report of the Managing Director to the Interim Committee on Progress in Strengthening the Architecture of the International Financial System*, International Monetary Fund, Washington D.C., 26 April 1999, p.2. http://www.imf.org/external/np/omd/1999/042699.htm

16 International Monetary Fund, *Report of the Managing Director to the Interim Committee on Progress in Strengthening the Architecture of the International Financial System*, International Monetary Fund, Washington D.C., 26 April 1999, p.2. http://www.imf.org/external/np/omd/1999/042699.htm

the new standards that are being set. National authorities need to ensure that those standards are first established and then met, and that supervisory and regulatory agencies are strengthened. It is important that areas of vulnerability are minimised through better management of macroeconomic and financial policies. The Fund and other international institutions and forums also need to ensure that their efforts are mutually reinforcing and effective.[17]

5.19 In a recent study for the Institute for International Economics in Washington, Professor Barry Eichengreen explained the complexities that the Asian Crisis had introduced into the task of reforming the international financial architecture:

> … That crisis … shows how counterproductive it is to think of Asia's financial collapse as a single event. The causes and consequences differed across countries. New financial crises unfolded upon old ones; by the spring of 1998, the IMF's managing director, Michael Camdessus, routinely referred to "crises within crises". To be sure these difficulties were related. But attempting to explain them all in terms of a single set of factors … is unlikely to be helpful. Rather, the Asian crisis suggests that understanding twenty-first-century crises will require one to weave together strands from different approaches. Correspondingly, proposals for reform must address the problems highlighted by each of the relevant models.[18]

5.20 The Report of the Task Force on International Financial Reform supported this assessment:

> No doubt all factors played a role and, as such, highlight that there is not a single solution to the crisis, nor a single measure that will achieve greater stability in global capital markets. Reform will require progress across a wide range of fronts, much of it focussed on sound policies at the national level: countries pursuing appropriate macroeconomic and regulatory policies were much less affected by the financial turmoil that affected others.[19]

17 International Monetary Fund, *Report of the Managing Director to the Interim Committee on Progress in Strengthening the Architecture of the International Financial System*, International Monetary Fund, Washington D.C., 26 April 1999, p.2. http://www.imf.org/external/np/omd/1999/042699.htm

18 Barry Eichengreen, *Toward a New International Financial Architecture: A Practical Post-Asia Agenda*, Institute for International Economics, Washington D.C., February 1999, p.143.

19 Task Force on International Financial Reform, *Report to the Prime Minister*, AGPS, CanPrint Communications, Canberra, 1998, p.3.

Criticism of IMF policies

5.21 Dr John Edwards of HSBC commented in his evidence that the weaknesses in the present arrangements had become apparent during the Asian Crisis:

> … we did see during the Asia crisis, the crisis in Russia, and the crisis that originated from Long-Term Capital Management in the US, that the current architecture of international financial arrangements is highly vulnerable, and did produce, in the case of Asia, a very severe outcome from which Asia is only just emerging.[20]

5.22 Bearing out Dr Edwards' comments, during the Asian Crisis the criticism of the IFIs, particularly the IMF, was more strident than ever before. Critics felt that policies were too rigid, recovery packages too harsh and, in some cases, the approach was simply considered to be wrong. For example, one commentator wrote:

> The world financial crisis of the last two years has prompted some of the most damning criticism ever of the Bretton Woods institutions, and particularly the International Monetary Fund. Should the Fund be razed, re-built or renovated? Renovation seems the most likely course. Three areas need attention: the Fund's role in crisis prevention and management, its approach to exchange rate regimes and its ways of governing itself. On the first it should pay more attention to micro matters; on the second, give up on pegged rates; and on the third, become flexible and representative.[21]

5.23 These comments sprang from wide-spread criticism that the Fund had failed to foresee the crisis and that when it did take action, its prescriptions did not work. Leading critics, Harvard economists Jeffrey Sachs and Martin F. Feldstein, asserted that the crisis was made worse by the IMF's unimaginative prescriptions. They blamed the Fund's policies for the capital flight from Asia and the deep economic contraction which followed. The Fund's recovery package was described as "an overdose of bitter medicine" – pressing governments to raise budget surpluses even higher than they were, tightening bank credit by increasing interest rates and the closing down of weak banks. All of this they claimed, prolonged

20 Evidence, Dr J. Edwards, 22 March 2000, p.96.

21 Wendy Dobson, *What To Do With The IMF?*, in Policy Options, July / August 1999, p.37.

asset-price deflation in the property sector and further eroded investor confidence.[22]

5.24 The Deputy Governor of Australia's Reserve Bank also voiced his misgivings about some of the policies applied by the IMF in Asia:

> … the IMF is seen, by many of us, to have been misguided in aspects of its response, at least to some of the countries in crisis (and here I am thinking in particular of Indonesia). A better deliberative process might have eased this problem; …[23]

5.25 Not all commentators agreed that the blame should be mainly carried by the IMF. An Assistant Professor at the University of San Francisco wrote:

> … the criticism that the Fund failed to anticipate the crisis is untenable. … the IMF's early-warning system *did* work. It not only foresaw the crisis in mid-1995, but senior IMF officials continually warned governments that the combination of pegged exchange rates, poor bank supervision and the build-up of short-term unhedged debt could prove disastrous. … What the IMF did *not* anticipate was the magnitude of the crisis, nor when it was likely to occur …[24]

5.26 Others suggested that the structure of the IMF operation is part of the problem:

> Although it has 182 members, the IMF is largely governed by the G7 (and mainly the United States) and it has kept its decisions and the rationale for its actions confidential. The IMF's Board of Governors, which is ultimately accountable for the Fund's direction, consists of eight individual large-country members and 16 members representing groups of countries. Members are assigned quotas and voting rights according to their economic clout….
>
> The G7 governments dominate decisions. Countries such as Singapore and Hong Kong, which have among the world's largest foreign reserves other than Japan and China, are represented only as part of multi-country constituencies. Taiwan is not a member.[25]

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22 Shalendra D. Sharma, *Asia's Economic Crisis and the IMF*, in Survival, Vol.40, No.2, International Institute for Strategic Studies, Summer 1998, p. 43.

23 Dr S. A. Grenville, Deputy Governor, *Globalisation and the International Financial Architecture: Writing (and Righting) the Rules*, Reserve Bank of Australia Bulletin, Sydney, July 2000, p.9.

24 Shalendra D. Sharma, *Asia's Economic Crisis and the IMF*, in Survival, Vol.40, No.2, International Institute for Strategic Studies, Summer 1998, p. 43.

25 Wendy Dobson, *What To Do With The IMF?*, in Policy Options, July / August 1999, p.41.

5.27 On a more pragmatic note, the Emerging Markets Committee of IOSCO, looking at the regulatory implications of the Asian Crisis, commented:

> The suddenness of the … crisis, the rapid spread of the financial contagion and the extent of the effects of the crisis have raised calls by various quarters for a review of the role of international financial institutions. … two [areas] are particularly relevant to this report.[26]

5.28 The Emerging Markets Committee then discussed the two areas of weakness in global surveillance arrangements that had been highlighted and called on the IFIs to reassess those arrangements. The first issue was the need for a system which would give adequate warning when the likelihood of a crisis increased - early enough to give remedial measures a high probability of success. The proposal was also put forward that IFIs be given sufficient resources and capacity to ensure that proper remedial action can be applied when imbalances appear.[27]

5.29 The second major issue was the establishment of efficient crisis management arrangements – to avoid the rapid spread of contagion so apparent in the Asian crisis. The report acknowledged that this would be a difficult task, given the high degree of integration in international financial markets and indicated that the help of international groupings would be needed and that domestic and international efforts would need to be complementary and coordinated.[28]

5.30 The IMF's Managing Director acknowledged the criticism of the organisation in an address to a symposium in Germany:

> We cannot deny the basic justification of these – at times vociferous – calls for change. No doubt there are at least some elements of validity in each of them. Taken together, they tell us that world public opinion expects its leaders not necessarily to redesign everything from scratch, as if we were back to Bretton

26 Emerging Markets Committee, IOSCO, *Causes, Effects and Regulatory Implications of Financial and Economic Turbulence in Emerging Markets*, Interim Report, The International Organization of Securities Commissions, Madrid, September 1998, p.79. http://www.iosco.org/docs-public/1998-causes_and_effects.html

27 Emerging Markets Committee, IOSCO, *Causes, Effects and Regulatory Implications of Financial and Economic Turbulence in Emerging Markets*, Interim Report, The International Organization of Securities Commissions, Madrid, September 1998, p.80. http://www.iosco.org/docs-public/1998-causes_and_effects.html

28 Emerging Markets Committee, IOSCO, *Causes, Effects and Regulatory Implications of Financial and Economic Turbulence in Emerging Markets*, Interim Report, The International Organization of Securities Commissions, Madrid, September 1998, p.80. http://www.iosco.org/docs-public/1998-causes_and_effects.html

> Woods; but neither should we limit ourselves to some plumbing and interior decorating of the old mansion.[29]

5.31 He went on to suggest five priority areas in which he considered the Fund should concentrate its efforts:

- efforts to make Fund surveillance more effective and development of a tiered response – i.e. increasingly strong warnings to countries seen to be seriously off course;
- improvement of the availability and transparency of information;
- strengthening financial and banking systems, as well as their supervision;
- establishment of more effective procedures to involve the private sector in preventing and resolving debt crises; and
- liberalisation of capital flows in a prudent and properly sequenced way.[30]

5.32 The Committee supported these proposals and commented that improving the transparency of the IMF's operations would be a very important factor in re-establishing the confidence of developing countries in the international financial system. Having said all of this, it should not be read as exonerating the leaders of these countries, who must bear the major responsibility for creating the climate that led to the Asian Crisis.

Moral hazard

5.33 One of the main criticisms of the operation of international financial organisations concerns the IMF's role as lender of last resort. Critics contend that this role creates a "moral hazard", a phenomenon that "occurs when those who take economic decisions are not required to take the full consequences, when that decision turns out badly."[31]

5.34 The argument is that foreign investors are "bailed-out" and not required to bear the financial cost of bad decisions. Theorists say that when investors are confident that the IMF will provide funding to avoid a system collapse, they are prepared to take greater risks. An example often used is the Mexican Crisis of 1994-5, when a sudden capital outflow was

29 Michael Camdessus, Managing Director of the IMF, *The IMF's Role in Today's Globalized World*, address to an IMF-Bundesbank Symposium, Frankfurt, Germany, 2 July 1998, p.4. http://www.imf.org/external/np/speeches/1998/070298.HTM

30 Michael Camdessus, Managing Director of the IMF, *The IMF's Role in Today's Globalized World*, address to an IMF-Bundesbank Symposium, Frankfurt, Germany, 2 July 1998, p.4. http://www.imf.org/external/np/speeches/1998/070298.HTM

31 Stephen Grenville, Deputy Governor of the Reserve Bank, *The Asia Crisis, Capital Flows and the International Financial Architecture*, talk to Monash University Law School Foundation, Melbourne, 21 May 1998, p.8.

stemmed by a US$ 50 billion support package. The critics saw this as a bad precedent, encouraging risky investment practices.[32]

5.35 The public reaction was summarised by hedge fund entrepreneur, George Soros:

> Moral hazard has become a big issue in the recent crisis. There has been a groundswell of political opposition to the idea that public funds should be used to bail out the private sector.[33]

5.36 The problem is that while everyone is theoretically against the concept of moral hazard, when it comes to practical situations, assistance is often essential to prevent a crisis from becoming even worse.[34]

5.37 An important issue to bear in mind is that, despite popular beliefs, even when a rescue package is applied, investors do not escape unscathed. Referring to the Asian Crisis, Karin Lissakers of the IMF commented in August 1998, that "few investors have gotten away scot-free". She added that equity investors and currency traders had taken big losses and banks were being forced to reschedule claims on Asia.[35]

5.38 The international financial community is still wrestling with the problem of moral hazard. The proposal gaining support at present is to find suitable policies which will ensure that the private sector is closely involved in any plans to deal with financial cries – a process becoming known as "bailing-in" the private sector. As Dr John Edwards explained it:

> … The idea is, instead of allowing private lenders to bail-out of a situation, you force them to remain; a very difficult issue for commercial banks.[36]

5.39 George Soros stressed that the problem is a serious issue which must be solved quickly:

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32 Stephen Grenville, Deputy Governor of the Reserve Bank, *The Asia Crisis, Capital Flows and the International Financial Architecture,* talk to Monash University Law School Foundation, Melbourne, 21 May 1998, p.8.

33 George Soros, *The New Global Financial Architecture,* in Eds Will Hutton and Anthony Giddens, On the Edge, Jonathan Cape, London, 2000, p.88.

34 Stephen Grenville, Deputy Governor of the Reserve Bank, *The Asia Crisis, Capital Flows and the International Financial Architecture,* talk to Monash University Law School Foundation, Melbourne, 21 May 1998, p.8.

35 Karin Lissakers, US Executive Director, IMF, *The IMF and Reforming the Global Financial Architecture*, interview August 1998. p.1. http://www.usia.go/journals/ites/0898/ijee/ejfliss.htm

36 Evidence, Dr J. Edwards, 22 March 2000, p.98.

> The main area of confusion remains the issue of bailing-in the private sector and the uncertainty can be very harmful.[37]

5.40 The risk of moral hazard is not confined to international transactions. Reserve banks face the same problems in dealing with domestic financial crises. An IMF paper commented that the proper response for national authorities is:

> … rigorous prudential supervision and regulation combined with careful design of the lender-of-last-resort facility to limit the scope and incentives for financial market participants to take on excessive risk. More generally, pursuing policies to develop a financial system that relies less heavily on banks and other intermediaries and involves more direct risk bearing by ultimate investors can help to reduce the risks of costly crises and moral hazard.[38]

This is a prescription which could equally well be applied to the international financial scene.

5.41 The Committee commented that international plans to closely involve the private sector in the prevention and containment of financial crises, could substantially reduce the incidence of moral hazard. It noted, however, that the problem of rapid, large scale, destabilising, movement of funds by the larger hedge funds, would not be addressed by this approach.

Progress in reforming the international financial architecture

5.42 The fallout from the Asian Crisis has led to a flurry of activity in international organisations, aimed at improving the operation of the international financial system. Much of this work comes under the surveillance of the IMF and the Fund produces a regular assessment of the progress made, in reports entitled: *Progress in Strengthening the Architecture of the International Financial System and Reform of the IMF.*

5.43 In the Report of 19 September 2000, the Fund reported that many of the initiatives already undertaken are designed to strengthen the operation of the international financial system. The aim is to use the closer integration

37 George Soros, *The New Global Financial Architecture*, in Eds Will Hutton and Anthony Giddens, On The Edge: Living with Global Capitalism, Jonathan Cape, London, 2000, p.89.

38 Barry Eichengreen and Michael Mussa, *Capital Account Liberalisation and the IMF*, in Finance and Development, December 1998, Vol 35, No.4, IMF. http://www.imf.org/external/pubs/ft/fandd/1998/12/eichen.htm

of the global economy to deliver economic growth and higher living standards throughout the world.[39]

5.44 Most of these initiatives are concerned with crisis prevention. They are designed to promote sound policies and increase the institutional strength of financial markets. This has involved initiatives in a wide array of sectors:

- improving transparency and accountability;
- better identifying vulnerable areas;
- strengthening domestic institutions, financial systems and policies;
- developing and implementing standards and codes of good practice in critical areas; and
- helping countries establish policy and institutional preconditions for successful capital account liberalisation and integration into global markets.[40]

5.45 The international effort has also been directed toward improvement of crisis management and resolution. The emphasis here is to ensure that policy responses incorporate an appropriate role for all creditors. The report notes that the IMF has finite resources and that efficient policy responses must therefore include a proper mix between official financing and the involvement of private creditors.[41]

5.46 The involvement of the private sector in crisis resolution and management remains a priority area. The Fund reports that it is now reasonably well accepted, that private sector creditors should play an appropriate role – and bear responsibility for the risks they undertake. To support these initiatives, the Fund has encouraged the adoption of policies to assist in crisis prevention and resolution; some examples are: creditor debtor communications, collective action clauses, and contingent lines of credit.[42]

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39 International Monetary Fund, *Progress in Strengthening the Architecture of the International Financial System and Reform of the IMF*, Report of the Managing Director to the International Monetary and Financial Committee, International Monetary Fund, Washington D.C., 19 September 2000, p.1. http://www.imf.org/external/np/omd/2000/02/report.htm

40 International Monetary Fund, *Progress in Strengthening the Architecture of the International Financial System and Reform of the IMF*, Report of the Managing Director to the International Monetary and Financial Committee, International Monetary Fund, Washington D.C., 19 September 2000, p.2. http://www.imf.org/external/np/omd/2000/02/report.htm

41 International Monetary Fund, *Progress in Strengthening the Architecture of the International Financial System and Reform of the IMF*, Report of the Managing Director to the International Monetary and Financial Committee, International Monetary Fund, Washington D.C., 19 September 2000, p.2. http://www.imf.org/external/np/omd/2000/02/report.htm

42 International Monetary Fund, *Progress in Strengthening the Architecture of the International Financial System and Reform of the IMF*, Report of the Managing Director to the International Monetary and Financial Committee, International Monetary Fund, Washington D.C., 19 September 2000, p.2. http://www.imf.org/external/np/omd/2000/02/report.htm

5.47 Regarding the review of its own operations, the IMF is examining whether its financing facilities and conditionality are able to respond effectively to the greater integration of domestic and international financial markets. It is also examining the safeguard arrangements within central banks and other counterpart agencies in its member countries – to ensure that they are adequate to sustain the integrity of operations and to manage resources, including IMF disbursements. A review has also commenced of quota formulas which determine the level of financial subscriptions to the IMF, access to IMF resources and relative voting shares.[43]

5.48 The Fund, of course, is not the only international organisation involved in the process of reforming the International Financial Architecture. The IMF report noted that other international groups and institutions are playing roles according to their own areas of responsibility. For its part, the Fund is intensifying and expanding arrangements for cooperation and coordination with those organisations.[44]

5.49 The IMF report states that many initiatives have already begun to be implemented, although the extent of progress varies substantially. Some examples are:

- making IMF policy advice public;
- improving data on international reserve positions;
- development of international standards; and
- greater disclosure on IMF activities.

Other projects still in the development stages include the assessment of:

- financial sector weaknesses; and
- observance of standards and codes.[45]

43 International Monetary Fund, *Progress in Strengthening the Architecture of the International Financial System and Reform of the IMF*, Report of the Managing Director to the International Monetary and Financial Committee, Washington D.C., 19 September 2000, p.2. http://www.imf.org/external/np/omd/2000/02/report.htm

44 International Monetary Fund, *Progress in Strengthening the Architecture of the International Financial System and Reform of the IMF*, Report of the Managing Director to the International Monetary and Financial Committee, Washington D.C., 19 September 2000, p.2. http://www.imf.org/external/np/omd/2000/02/report.htm

45 International Monetary Fund, *Progress in Strengthening the Architecture of the International Financial System and Reform of the IMF*, Report of the Managing Director to the International Monetary and Financial Committee, Washington D.C., 19 September 2000, p.2. http://www.imf.org/external/np/omd/2000/02/report.htm

5.50 The disruption produced by the Asian Crisis has forced the IMF to review its own operations and the report commented on the changes which have resulted. It noted that surveillance has been strengthened and greater attention paid to indicators of vulnerability and to exchange rate issues.[46]

5.51 The Fund has acknowledged that refining the International Financial Architecture will be a continuing process, as technology and techniques in the markets change. It has also recognised that it will increasingly have to take on the role of central coordinator in financial stability issues. Finally, it will have to be ready to assist member countries to develop the policies and institutions needed to realise the benefits of globalisation in financial markets.[47]

5.52 The Fund's ability to carry out these tasks has been increased in the last few years by changes to the funding received from member governments. In 1997 a supplemental reserve facility was put in place. This facility is for the provision of loans to countries in crisis – the loans carrying a penalty interest rate. Quotas were increased in 1998 – allowing individual countries access to greater levels of funding. In 1999, a contingent credit line was established; this will be available on stringent conditions and is intended for countries seeking to prevent a crisis.[48]

Conclusion

5.53 The Committee concluded that there is a continuing need for review and reassessment of the operations (and the charters) of the International Financial Institutions. It considered that the rules applied to these bodies, are no longer adequate for the economic conditions in which they operate. Accordingly they are in urgent need of modernisation.

46 International Monetary Fund, *Progress in Strengthening the Architecture of the International Financial System and Reform of the IMF*, Report of the Managing Director to the International Monetary and Financial Committee, Washington D.C., 19 September 2000, p.3. http://www.imf.org/external/np/omd/2000/02/report.htm

47 International Monetary Fund, *Progress in Strengthening the Architecture of the International Financial System and Reform of the IMF*, Report of the Managing Director to the International Monetary and Financial Committee, Washington D.C., 19 September 2000, p.3. http://www.imf.org/external/np/omd/2000/02/report.htm

48 Wendy Dobson, *What To Do With The IMF?*, in Policy Options, July/August 1999, p.39.

Recommendation 5

5.54 **The Committee recommends that:**

- **Australia continue its strong support for the review of the International Financial Architecture with the aim of modernising its institutions;**
- **the Government 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.**

6

Role of hedge funds (highly leveraged institutions)

6.1 One of the main sources of pressure on the international financial system has come from the operations of a few very large hedge funds. The Committee took note of this fact and examined the nature and activities of hedge funds very closely.

Nature of hedge funds

6.2 The activities of Hedge Funds have been blamed by some commentators, at least in part, for the financial chaos which struck Asia during the Asian Crisis. These funds have fallen under suspicion because the small number of very large funds are individually capable of moving large amounts of capital into, or out of, an economy very rapidly. They have also been accused of using their large asset base to manipulate the market and force price changes favourable to their policies.

6.3 Hedge funds take a variety of forms and there seems to be no fixed definition which fits them all. In the United States, the Report of the President's Working Group on Financial Markets adopted the following description as a working definition:

> The term "hedge fund" is commonly used to describe a variety of different types of investment vehicles that share some similar characteristics. Although it is not statutorily defined, the term encompasses any pooled investment vehicle that is privately

organised, administered by professional investment managers, and not widely available to the public.[1]

6.4 The Report commented that the primary investors in hedge funds are wealthy individuals and institutional investors and that fund managers frequently have a financial stake in the fund they manage. Hedge funds are commonly either limited partnerships or limited liability companies and are frequently located offshore from the economy in which they are investing.[2]

6.5 Goldman Sachs & Co. described the term 'hedge funds' as including:

> … a broad range of risk and return objectives. The common element among these strategies is the use of investment and risk management skills to seek positive returns regardless of market direction.[3]

6.6 In its submission to this inquiry, the Reserve Bank provided the following description:

> Their typical characteristics are: they are limited partnerships whose main function is investment management; they are generally run out of the US, though legally are domiciled in offshore tax havens; they do not solicit funds directly from the public or advertise, but attract investors by word of mouth; and they have high minimum investment levels, ranging between US$100,000 to US$5 million, with US$1 million common. These latter characteristics allow them to gain exemptions from various US federal securities laws, such as Securities and Exchange Commission (SEC) reporting, regulatory restrictions on leverage and trading strategies, and investor protector legislation.[4]

6.7 An article in the *Journal of Empirical Finance* explained that hedge funds are regarded as private investment vehicles for wealthy individuals or institutional investors. The investors are limited partners and the managers are general partners. The managers invest a significant proportion of their private wealth in the fund to ensure that economic interests are mutual. Fees are performance based and successful managers

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1 Report of the President's Working Group on Financial Markets, *Hedge Funds, Leverage, and the Lessons of Long-Term Capital Management*, US Government Printing Office, Washington D.C., April 1999, p.1.

2 Report of the President's Working Group on Financial Markets, *Hedge Funds, Leverage, and the Lessons of Long-Term Capital Management*, Washington, April 1999, p.1.

3 Goldman Sachs & Co. and Financial Risk Management Ltd, *Hedge Funds Demystified: Their Potential Role in Institutional Portfolios,* Pension and Endowment Forum, July 1998, p.5.

4 Submission No.7, Reserve Bank of Australia, 24 June 1999, Attachment 1, p.1.

command fees significantly above the normal fixed fee structure for mutual funds.[5]

6.8 The same article described the main difference between hedge funds and mutual funds as based on their different trading strategies. The authors noted that hedge funds used dynamic strategies, while mutual funds tended to a static 'buy and hold' strategy. In addition, hedge funds make extensive use of leverage in their investments. Hedge funds were described as typically using margin positions and short sales to leverage their bets. For mutual funds, access to leverage options is usually limited or restricted by their rules of operation.[6]

6.9 The main difficulties arise because, as described above, many hedge funds are not subject to the normal reporting and disclosure requirements faced, for example, by a bank. The Reserve Bank commented that the larger hedge funds are the only systemically important institutions not subject to regulation.[7]

6.10 The Financial Stability Forum Working Group on Highly Leveraged Institutions, produced a report in April 1999 which examined the activities of organisations described by IOSCO and the Basle Committee as: unregulated, opaque and large institutions which employ a high degree of leverage in financial markets. The Working Group observed that most of the institutions falling within this group were large, highly leveraged hedge funds.[8]

6.11 The Working Group report noted especially, that the use of leverage is a characteristic common to all of the institutions in their focus group and explained:

> Leverage typically arises because hedge funds use financial instruments (such as repos[9], futures and forward contracts and other derivative products) where positions can be established by posting margins rather than the full face value of the position. This leverage is established from relationships with financial institutions, either through counterparty transactions or through the use of prime brokerage services, … Hedge Funds only

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5 W. Fung and D. Hsieh, *A Primer on Hedge Funds*, Journal of Empirical Finance 6 (1999), p. 310.

6 W. Fung and D. Hsieh, *A Primer on Hedge Funds*, Journal of Empirical Finance 6 (1999), p. 314.

7 Submission No.7, Reserve Bank of Australia, 24 June 1999, Attachment 1, p.4.

8 Financial Stability Forum, *Report of the Working Group on Highly Leveraged Institutions*, 5 April 2000, p.7. http://www.fsforum.org/Reports/RepHLI.html

9 Repurchase Agreement: an exchange of securities for cash which will be reversed at an agreed date and price.

infrequently obtain conventional loans from financial institutions.[10]

6.12 The Report also explained that obtaining a useful measure of leverage is difficult:

> Measuring leverage is neither straightforward nor synonymous with measuring risk … But, … high leverage (and the means through which it interacts with credit, market and liquidity risk) can give rise to significant concern.
>
> Evaluating the risk adjusted performance of hedge funds is difficult because of their dynamic trading strategies.[11]

6.13 The question of disclosure requirements weighs heavily in determining the financing arrangements for hedge funds. The Journal of Empirical Finance explained that a fund manager with a 'winning strategy' avoids arrangements which require high levels of transparency and disclosure (e.g. mutual funds). They opt instead for 'private vehicles' which have much lower transparency and disclosure requirements. This explains also why hedge fund membership is generally restricted to the wealthy, who are presumed to need little consumer protection in making investment decisions.[12]

The problems with hedge funds

6.14 Most of the funds, in fact, cause few problems but some of the larger funds are able to cause destabilising movements in the markets. A favourite tactic is to build up very large positions in a chosen market and, having influenced prices in their own favour, rapidly move those funds to another market or market sector. The Reserve Bank commented:

> A variety of strategies have been used by hedge funds. Some of these strategies have been designed not just to take advantage of expected price movements, but to *cause* price movements.[13]

6.15 The effect of these rapid movements of very large sums is to distort the normal adjustment of currency markets, causing them to 'overshoot' and

10 Financial Stability Forum, *Report of the Working Group on Highly Leveraged Institutions,* 5 April 2000, p.9. http://www.fsforum.org/Reports/RepHLI.html

11 Financial Stability Forum, *Report of the Working Group on Highly Leveraged Institutions,* 5 April 2000, pp.7 & 10. http://www.fsforum.org/Reports/RepHLI.html

12 W. Fung and D. Hsieh, *A Primer on Hedge Funds,* Journal of Empirical Finance 6 (1999), p. 317.

13 Submission No.7, Reserve Bank of Australia, 24 June 1999, Attachment 1, p.4.

adding to the volatility of the market processes. The Reserve Bank explained:

> While there is only a small number of such funds, their investment approach of aggressive position-taking has the potential to exacerbate stresses in world markets. It should be of concern to policy makers that, as well as positioning themselves to take advantage of expected market developments (which is a perfectly legitimate activity), these funds at times also try to influence the course of those developments. Their ability to do this reflects not only the size of their position-taking relative to some of the markets in which they operate, but their influence on the behaviour of other market participants because of the reputation they enjoy.[14]

6.16 The activities of the hedge funds came under close scrutiny in the Asian crisis but assessments of their role are sharply divided. The Reserve Bank is of the opinion that the attitude in western countries was shaped by an IMF report *Hedge Funds and Market Dynamics*, which took a sceptical view of the hedge funds' role. The RBA's summation was that:

> … some might regard the actions of hedge funds as described by the IMF as the ultimate in destabilising behaviour: they came into a market that was already under intense pressure and sold a large volume, pushing the currency over the brink.
>
> Overall, the Bank's view is that the role of hedge funds in the events of 1997 and 1998 in the Asia / Pacific region have been dismissed too readily.[15]

6.17 The Reserve Bank submission also noted that at the beginning of the Asian crisis, the short position built up by the hedge funds in Thai baht was equivalent to almost 5% of Thailand's GDP. The Reserve Bank suggested that this can hardly be ignored, as it applied almost as much pressure to the Thai currency as the country's current account deficit – widely seen as a major cause of the crisis.[16]

6.18 In evidence the Reserve Bank commented that Australia had observed the activities of hedge funds in Australia, South Africa and Hong Kong and had expressed its disquiet about some of those activities:

> We were somewhat disturbed by what we saw and we mentioned this in various international forums, usually to relatively

14 Submission No.7, Reserve Bank of Australia, 24 June 1999, p.2.

15 Submission No.7, Reserve Bank of Australia, 24 June 1999, p.3.

16 Submission No.7, Reserve Bank of Australia, 24 June 1999, p.2.

> unsympathetic ears. We found ourselves very much on the side of our neighbours and felt they had a legitimate complaint to make about some of the activities of the hedge funds.[17]

Australia's experience with hedge funds

6.19 Despite the overall strength of the Australian financial system, it too was severely tested by the activities of the large hedge funds. A paper from the Reserve Bank highlighted the disruptive effects of their activities in 1998:

> … the activities of hedge funds came to dominate the market during the middle of the year, affecting the dynamics of price discovery for the period while this dominance continued. This occurred despite the fact that the Australian dollar is floating, so that there was no fixed exchange rate to attack as there was in Hong Kong or, …, in the UK in 1992.[18]

6.20 Australia's floating exchange rate is intended to insulate the economy from the shocks transmitted by changes in the terms of trade. In normal circumstances the Reserve Bank does not interfere with these fluctuations – it intervenes only when the fluctuations are wider than expected, given the underlying economic circumstances; i.e. when the currency is overshooting instead of returning to a stable equilibrium. In evidence, the RBA said:

> The danger with the fixed exchange rate is that it is brittle. It is either working perfectly or it collapses. …
>
> The centrepiece of any risk strategy, I think, if you can do it – and some countries cannot do it – is to have a floating exchange rate where people are accustomed to exchange rates going up and down and where borrowers, particularly corporations and banks, understand foreign currency risk.[19]

6.21 The hedge funds sought to take advantage of the Reserve Bank's restraint in the midst of the Asian crisis in mid-1998. In a situation where the Australian dollar was already falling in value, the major hedge funds established very large "short" positions in the Australian dollar; i.e. they were selling not only their own holdings of Australian currency but

17 Evidence, Reserve Bank of Australia, 9 February 2000, p.6.

18 Bob Rankin, *The Impact of Hedge Funds on Financial Markets: Lessons from the Experience of Australia*, Reserve Bank of Australia, Paper prepared for the RBA Conference on Capital Flows and the International Financial System, Sydney, 9-10 August 1999, p.1.

19 Evidence, Reserve Bank of Australia, 9 February 2000, p. 5.

entering into contracts to sell currency they did not yet own (covered by credit from the banks). The aim of this strategy was to sell at say US$0.70, force the dollar's value down even further, then buy it back at a lower price (say US$0.68), settle the amounts they had borrowed and make a large profit on the transactions.

6.22 A central factor in the hedge funds' strategy was their expectation that the Reserve Bank would not be able to intervene effectively because of the huge volume of currency available to the funds (their borrowings alone were estimated at $12 billion in May 1998). As their first move, the funds let the rest of the market know that they intended to attack the Australian dollar and, predictably, the news increased uncertainty in the market and effectively deterred potential buyers. The funds relied also on the phenomenon of "herd behaviour", where market participants either follow en mass when a new strategy is applied or sit back and wait to see what others are going to do:

> The key features of hedge funds' activities were the signalling to other market players that they were about to attack the $A (a move which heightened uncertainty and deterred potential buyers from remaining in the market); lowering offer prices in the brokers even though they were able to sell all they had on offer at the existing price; and concentrating sales into periods of thin trading. One consequence was that exporters, who had been keen buyers of $A at higher levels, not only stopped buying but began to sell in the expectation that the exchange rate would fall further – a classic example of herd-like behaviour.[20]

6.23 In this instance the herd behaviour took the form of waiting to see what the hedge funds would do. Even exporters, who would have been expected to buy strongly in response to the low value of the dollar, were selling. Many exporters had been caught out by buying in at higher values, thinking the market had already reached the bottom. For the Australian market generally this was a bad period, because the reluctance of buyers removed liquidity from the system at a time when it was vitally needed. This became even more serious when, influenced by pessimism about low commodity prices, the Australian dollar began to fall against even weak currencies.

6.24 When the exchange rate fell outside the range regarded as reasonable for the ruling economic conditions, the Reserve Bank intervened in the market. The RBA spent $A 2.6 billion in three days buying Australian currency. When the hedge funds did not renew the assault, other buyers returned to the market and the pressure receded.

20 Submission No.7, Reserve Bank of Australia, 24 June 1999, p.3.

6.25 Over the fifteen years prior to 1998, the value of the Australian dollar fluctuated widely around a mean value of US 73cents. At the worst period of the hedge funds' attack, it fell to US 55.3cents. At that point, in addition to the activities of the Reserve Bank, the hedge funds found their credit from the banking system restricted in the wake of the near-collapse of the giant hedge fund Long-Term Capital Management.

6.26 This fund, managed by several winners of the Nobel Prize for Economics, came close to bankruptcy. It was rescued by a consortium when the US banking system decided in effect that it was "too big to be allowed to fail". For the hedge funds as a group, it signalled the beginning of a more cautious approach to credit on the part of the banking system and an end to their efforts to force down the value of the Australian dollar. The Reserve Bank commented to the Committee that:

> I think that when that collapsed … it was important enough to actually cause the US Fed to change monetary policy. I have to say as well that that the collapse of Long term Capital Management actually took a lot of the pressure off. I think it punctured the reputation the hedge funds had. Hedge funds were able to be effective because they had an enormous reputation, all or most of which flowed from the collapse of sterling in 1992, which was attributed to the hedge funds.
>
> People were saying, 'Aren't the hedge funds powerful?' and, even more worryingly, 'Aren't they always right?' Once they got this reputation it became very easy for them to borrow money and very easy to take big positions and very easy to get other people to imitate them, thinking that they are bound to make money if they do what the hedge funds do. So for a time they were quite formidable. But I think that is not the case now. I think with the collapse of Long Term Capital Management and the fact that some of the others have done very badly and got a few bets wrong, some of them are now a lot smaller than they were, at least for the time being they have become a much smaller force than they were in 98.[21]

6.27 The Reserve Bank expressed its concern over this deliberate attempt to manipulate the $A and called attention also to earlier examples of similar activity. One example was the sharp change in the US$/Yen exchange rate in 1998, described by the Bank as one of the largest changes in a major country's exchange rate since the start of floating about 30 years ago. The rate fell about 25% in a little over a month, of which 15% occurred in 30 hours. The Bank suggested that it was significant that: "The timing of the

21 Evidence, Reserve Bank of Australia, 9 February 2000, pp. 6-7.

move and the feedback from the market makers both pointed directly to the central role of hedge funds …”.[22]

6.28 The submission from the Reserve Bank explained the dangers of this type of price manipulation:

> Australia has fully open markets, and market participants are free to buy or sell as they see fit. Nonetheless, the size of the positions taken by hedge funds, in Australia (and even more so in Hong Kong and Thailand) and their apparent intention to then force a change in the price, raises concerns about the possibility of market disruption. Notably, they were not merely transacting to take advantage of expected events but were doing so in a way which seemed intended to try to influence the course of events, posing a risk to market integrity.[23]

6.29 In evidence to the Committee, Dr John Edwards observed that the actions of the hedge funds in 1998 had made the Australian currency much more volatile than it need have been. He added that had the funds been more successful, they could:

> … have forced the Australian Reserve bank into monetary policy actions that would have had a very unfavourable effect on domestic growth. Even though we escaped the capital inflow issues of the Asia crisis, we ourselves did demonstrate a vulnerability to the impact of highly leveraged institutions.[24]

Action required

6.30 Some commentators argue that legislative restraints should be placed on the activities of the hedge funds. Others argue just as passionately that the bulk of the hedge funds are misrepresented by being included with the giant funds and should not be punished for the activities of a few. Still other commentators suggest that the activities of hedge funds are little different to those of commercial and investment banks and that the average gearing of hedge funds is lower than that of those banks. The Reserve Bank's response to this approach was that:

> These comparisons are of very limited value because:

22 Submission No.7, Reserve Bank of Australia, 24 June 1999, p.4.

23 Submission No.7, Reserve Bank of Australia, 24 June 1999, p.4.

24 Evidence, Dr J. Edwards, 22 March 2000, p.96.

- the bulk of hedge funds, particularly the global macro funds which are generally identified with recent financial crises, do not report their gearing; and
- the figures that are reported are based on balance sheet totals. Since it is widely acknowledged that hedge funds rely principally on off-balance sheet techniques (futures, forward contracts etc) to obtain leverage, the reported figures are largely meaningless. (Note that the reported figures are not audited in any way.)[25]

6.31 The RBA added that there is no reliable data on the gearing of hedge funds generally. The only fund for which information is available is Long Term Capital Management (the fund which almost collapsed) and it indicated a very high level of gearing of 25:1 even before the crisis, and outstanding contracts to a value of about 300 times the fund's capital.[26]

6.32 The Reserve Bank commented on the relative business approaches of the hedge funds and other financial organisations, such as banks:

> … comparisons between hedge funds and commercial and investment banks based purely on gearing ratios are misleading, as they do not take into account the very different business approaches of the various types of institutions. The great bulk of commercial and investment bank balance sheets are devoted to supporting client businesses rather than position taking. … In contrast, hedge funds' positions are concentrated and centrally controlled. … individual positions of banks tend to be smaller and less strongly held, and therefore less likely to have effects on markets. Also banks are mindful of their wide-ranging relationships with governments and businesses … and therefore less inclined to pursue strategies which could disrupt a country's markets and harm the bank's reputation. Hedge funds, in contrast, have no on-going relationships with most of the countries in which they trade and hence can be purely opportunistic.[27]

6.33 The RBA argued that the relative size of the asset bases of hedge funds and other financial institutions (such as banks, mutual funds, life offices, etc) is not the main determinant of their influence in the market. Although hedge funds have a smaller asset base than a bank, for example, they achieve greater market influence (or leverage) through the use of off-balance sheet transactions. The most potent factor is the ability of hedge

25 Submission No.7, Reserve Bank of Australia, 24 June 1999, pp.4-5.

26 Submission No.7, Reserve Bank of Australia, 24 June 1999, p.5.

27 Submission No.7, Reserve Bank of Australia, 24 June 1999, p.5.

funds to change their position rapidly. Banks have limited asset mobility because their main business is not position-taking in the market. Similarly, institutions such as mutual funds, life offices and pension funds are constrained by the industry benchmarks they follow.[28]

6.34 The Financial Stability Forum Working Group made an assessment of the systemic risks posed by hedge funds and other highly leveraged institutions. It divided its approach into two main categories:

> First, how best to address and reduce risks arising from the accumulation of leverage – and its interaction with other risks – to levels that pose systemic threats.
>
> Secondly, how to lessen the potential market and economy wide impact of the sudden and disorderly collapse of an unregulated [highly leveraged institution].[29]

6.35 The Group highlighted the potential problems for financial system stability, posed by highly leveraged positions:

- where risk exposure is increased, the enterprise is more exposed to positions which turn against it;
- if the firm defaults, the unwinding of its position could affect the solvency of its creditors; and
- leveraged positions are much more exposed if losses occur from credit, market or other risks – less capital is available to deal with the loss. This might mean rapidly closing out a position and producing exaggerated price effects.[30]

6.36 Leverage allows a larger position than the market conditions would normally justify. Unwinding these large positions can amplify the price effects and increase market volatility – this, in turn, can produce unpredictable price fluctuations in other markets. Once this process begins, it can affect the positions established by the firm itself and its counterparties.[31]

6.37 Commenting on the near-collapse of Long Term Capital Management, the Financial Stability Forum's Working Group drew attention to the failure of risk management assessments by the fund itself and by its counterparties. The Group's report noted that:

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28 Submission No.7, Reserve Bank of Australia, 24 June 1999, p.5.

29 Financial Stability Forum, *Report of the Working Group on Highly Leveraged Institutions*, 5 April 2000, p.12. http://www.fsforum.org/Reports/RepHLI.html

30 Financial Stability Forum, *Report of the Working Group on Highly Leveraged Institutions*, 5 April 2000, p.15. http://www.fsforum.org/Reports/RepHLI.html

31 Financial Stability Forum, *Report of the Working Group on Highly Leveraged Institutions*, 5 April 2000, p.15. http://www.fsforum.org/Reports/RepHLI.html

> Due diligence in individual credit decisions is the constraint on leverage, both at any one firm and in the economy as a whole, in a market economy. If a counterparty of an individual lender provides insufficient information for this judgement to be made, … , that credit provider should limit exposures accordingly. But that did not happen.
>
> … it is clear that collateral practices failed appropriately to assess and provide for future credit exposures …, partly through underestimation of the interaction of market risk, market liquidity risk and credit exposures. In an environment in which the complexity of risk exposures and their interaction is growing, it is worrying that even the most sophisticated firms should have been unable to assess this potential and limit exposures accordingly.[32]

6.38 The international financial authorities and the regulators in countries such as the G7 members, seem to have concluded that attempts to directly regulate hedge fund activities will not achieve the desired aims.

6.39 The balance of opinion is in favour of requiring greater transparency from sectors, such as banking, which provide the hedge funds with the financial backing which underpins their leverage. The Reserve Bank indicated that it is in general agreement with this approach:

> … We are probably inclined to think it would be too difficult to regulate them and that you can probably achieve most of what you want by relying on disclosure rather than regulation. It is probably not, at this stage, necessary to go down the regulation path. … At the moment we think enough is being done internationally in terms of re-examining their role and trying to improve disclosure.[33]

6.40 To reinforce that policy, there is also strong support for proposals that organisations offering derivative products be required to provide complete disclosure of the product details. This would especially include details of the product's risk profile. The availability of this additional information would enable investors to make a proper assessment of the product and its risks. This, in turn, would reduce the likelihood of firms becoming overexposed to adverse market changes. The Reserve Bank commented:

> Following the events of 1998 I think the international community looked at problems in two respects: one was to examine the

32 Financial Stability Forum, *Report of the Working Group on Highly Leveraged Institutions*, 5 April 2000, p.16. http://www.fsforum.org/Reports/RepHLI.html

33 Evidence, Reserve Bank of Australia, 9 February 2000, p.7.

> relationship between hedge funds and the people who were lending to them, mainly banks, and the other was to look at the degree of disclosure that hedge funds submitted to. … one of the problems was that because the hedge funds had developed such a powerful reputation and were putting so much business through the financial markets, banks were very keen to do business with them and lending to them on terms that demanded much less disclosure than banks would typically require of other customers.[34]

6.41 Reflecting this convergence of opinion, the Financial Stability Forum Working Group on Highly Leveraged Institutions (HLI), included in its report a range of recommendations designed to promote and sustain adjustments in firm behaviour and to enhance market discipline.

6.42 In summary, the recommendations proposed:

- stronger counterparty risk management;
- stronger risk management by hedge funds;
- enhanced regulatory oversight of HLI credit providers;
- greater risk sensitivity in bank capital adequacy regulation;
- sustaining industry progress in risk management;
- building a firmer market infrastructure;
- enhanced public disclosure by HLIs;
- enhanced public disclosure practices generally;
- enhanced national surveillance of financial market activity; and
- the establishment of good practice guidelines for foreign exchange trading.

6.43 The Financial Stability Forum referred the Group's report and recommendations to the G7 and G20 Ministers and Governors, the heads of the IMF and the World Bank. The Forum urged these bodies and others mentioned in the Group's report, to consider the recommendations promptly and take action to implement them.

34 Evidence, Reserve Bank of Australia, 9 February 2000, pp.7-8.

Recommendation 6

6.44 **The Committee recommends that adoption of the proposals of the Financial Stability Forum Working Group on Highly Leveraged Institutions, should be given urgent consideration. The proposals are that there should be:**

- **stronger counterparty risk management;**
- **stronger risk management by hedge funds;**
- **enhanced regulatory oversight of Highly Leveraged Institution credit providers;**
- **greater risk sensitivity in bank capital adequacy regulation;**
- **sustained industry progress in risk management;**
- **a firmer market infrastructure;**
- **enhanced public disclosure by Highly Leveraged Institutions;**
- **enhanced public disclosure practices generally;**
- **enhanced national surveillance of financial market activity; and**
- **established good practice guidelines for foreign exchange trading.**

7

Derivatives

7.1 Some commentators have claimed that many of the problem areas in international finance arise from the use of highly complex, unrestricted, derivative products.[1] The Committee noted that hedge funds, in particular, are active in the use of derivative products to increase their leverage. Consequently the Committee examined in some detail the nature and uses of derivatives.

Definition of derivatives

7.2 In their simplest form derivatives are products which 'derive' their value from another source, e.g. a bond linked to changes in the $US exchange rate and whose value varies with that rate. Frank Partnoy of Morgan Stanley (a former derivatives trader) described them as follows:

> A derivative is a financial instrument whose value is linked to, or derived from, some other security, such as a stock or bond. For example, you could buy IBM stock; alternatively, you could buy a 'call option' on IBM stock, which gives you the right to buy IBM stock at a certain time and price. A call option is a derivative because the value of the call option is 'derived' from the value of the underlying IBM stock. If the price of IBM stock goes up, the value of the call option goes up, and vice versa.[2]

7.3 A report by the Parliamentary Joint Committee on Corporations and Securities in 1995 defined derivatives more explicitly:

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1 For example: Sydney Futures Exchange Limited, *Surviving with Derivatives: What Directors Need to Know*, June 1995, p.1.

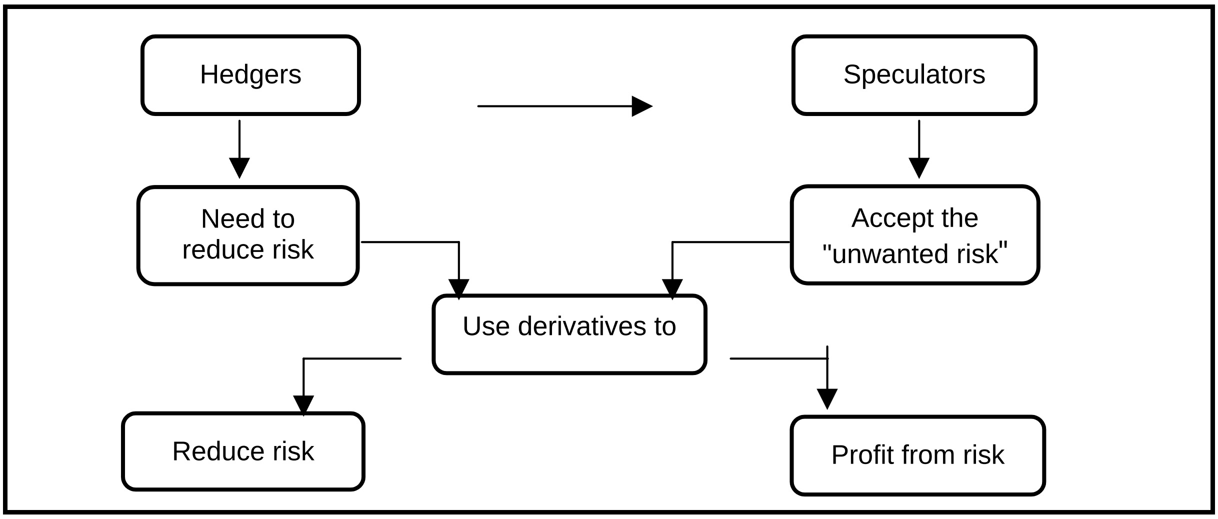
2 Frank Partnoy, *F.I.A.S.C.O., Blood in the Water on Wall Street*, W.W.Norton &Co., 1997, p.31.

> Derivatives are financial products which derive changes in their value from the price of an underlying commodity, security, currency, cash flow or index. The main types of derivatives are futures, options and swaps[3], although the range of derivatives products is continually expanding and many derivatives combine features of more than one type.[4]

In fact, the types of derivatives, and their complexity, are only limited by the imagination of the traders who invent them.

7.4 A paper by the Sydney Futures Exchange commented that fundamentally, derivatives were developed for the purpose of risk management. They facilitate the transfer of risk from those seeking to minimise their risk, to those who are prepared to accept the unwanted risk in the hope of a good return on their investment.[5]

Figure 1: Derivatives facilitate the transfer of risk



Source Reproduced from a diagram in Sydney Futures Exchange Booklet, Demystifying Derivatives, Sydney Futures Exchange, Sydney, 1998, p.4.

7.5 In a derivative contract, the medium and rate of repayment are specified in detail. This may involve currency, securities or a physical commodity

3 Futures and forward rate agreements involve an agreement to buy or sell an asset at a given price on a future date. Options contracts give one party the right (but not the obligation) to buy or sell an asset in the future. Swaps involve an interest rate or currency exchange, e.g. an interest rate swap may oblige one party to pay a fixed interest rate to another party in return for a floating interest rate.

4 Parliamentary Joint Committee on Corporations and Securities, *Report on Derivatives*, 20 November 1995, para.1.3, pp.1-2.

5 Sydney Futures Exchange Booklet, *Demystifying Derivatives*, Sydney Futures Exchange, Sydney, 1998, p.4.

such as gold or silver. The actual amount to be repaid may be linked to the movement of interest rates, stock indexes or a foreign currency. A contract may also include an element of 'leverage', which serves to multiply the impact (whether it be good or bad) of the derivative contract on the repayment obligations.[6]

7.6 The various types of derivatives can be separated into two broad categories:

- Exchange-traded derivatives are, as their name suggests, traded through the stock markets and consequently are subject to the rules and disciplines of those markets. They generally fall within very standard types.
- Over-the-Counter (OTC) derivatives, which are not standardised but custom-made for the customer and are not traded through stock exchanges. They are also not subject to the controls which apply to exchange-traded products.

7.7 An important feature of the trade in derivatives is that as their complexity grows, it becomes more and more difficult to determine accurately the key value of any particular derivative – its *present value*. This is the value which a product has for an investor now. It is defined as "The current value of a future cash flow discounted at an appropriate interest rate"[7]. Those traders who are particularly skilled at calculating present values accurately and quickly for complex derivatives, are highly valued by their employers.

Difficulties with derivatives

7.8 The more complex OTC derivatives have been the cause of some disastrous losses in foreign-exchange markets in recent years. A particular problem is the difficulty faced by investors in assessing the present value and the level of risk associated with such complex products. There is ample evidence in the literature that products are deliberately fashioned to confuse the buyer and to hide the high level of risk attached to them.

7.9 An extra element of confusion is introduced into the market by the practice of slicing an investment into 'strips' – e.g. 10 strips of $10 each from a $100 investment. Each strip is then combined with one or more strips from other investments and each of the composite packages is sold separately.

6 Pennsylvania Securities Commission, A Brief Guide to Financial Derivatives, 27 July 1999, p.1. http://www.state.pa.us/PA_Exec/Securities/corpfin/derivbro.html

7 Reuters Limited, *Reuters Glossary of International Financial and Economic Terms*, Edited by the Senior Staff of Reuters Limited, 3rd Edition, Longman Group Limited, Essex, UK, 1994, p.99.

7.10 In the face of this type of complexity, investors tend to rely on the advice of ratings agencies, such as Standard and Poor's or Moody's, which purport to evaluate risk levels and assign an appropriate rating to each type of investment. The process is not, however, as clear cut as it first appears. A practice has grown up in the ratings agencies of allowing traders to raise the rating assigned to their product by including a small strip of a highly rated product: such as a AAA rated US Treasury Bond. Using this technique it has been possible for traders to get a AAA rating for derivatives which consist mainly of highly speculative and volatile investments.

7.11 The advantage for some companies which utilise the more complex types of derivatives, lies in the fact that, in many cases, the obligations entered into do not have to appear on their balance sheets. It is therefore possible to disguise highly risky activities as something much more innocuous and even to hide losses on these activities for considerable periods of time.

7.12 Some of these extremely complex derivatives have been the source of such disruption in the marketplace (and the cause of such huge losses to some investors), that it is worthwhile to consider in some detail how one of these products works. The following extract is taken from the story of a Wall St derivatives trader:

> … early on I learned about one derivatives trade that I think exemplifies the group's business. This particular trade, and its acronym, were among the group's most infamous early inventions, although it is still popular among certain investors. The trade is called PERLS.
>
> PERLS stands for Principal Exchange Rate Linked Security, so named because the trade's principal repayment is linked to various foreign exchange rates, such as British pounds or German marks. PERLS look like bonds and smell like bonds. In fact, they *are* bonds – an extremely odd type of bond, however, because they behave like leveraged bets on foreign exchange rates. … instead of promising to repay the investor's principal at maturity, the issuers promise to repay the principal amount multiplied by some formula linked to various foreign currencies.
>
> … With PERLS, investors who were not permitted to bet on foreign currencies could place such bets anyway. Because PERLS looked like bonds, they masked the nature of the investor's underlying bet. For example, one popular PERLS, instead of repaying the principal amount of $100, paid the $100 principal amount multiplied by the change in the value of the US dollar, plus twice the change in the value of the British pound, minus twice the change in the value of the Swiss franc. … If you

> understood what you were buying, you hoped to receive a lot more than $100, although you knew you could receive a lot less. If the foreign currency rates went the wrong way – if the dollar and pound zigged while the franc zagged – you could lose every penny.
>
> In a clever but somewhat dubious marketing pitch for PERLS, … salesmen often bragged that the investor's "downside was limited to the size of the initial investment". These words appeared as boilerplate throughout Morgan Stanley's marketing documents and almost always generated snickers from the salesmen. One of the ironic selling points of PERLS – and many other derivatives my group later sold – was that the most a buyer could lose was everything.[8]

7.13 The problems presented by this type of activity were serious enough to compel the Sydney Futures Exchange to state:

> Wide publicity has been given to the dramatic losses in derivative markets by large overseas corporations, government bodies and … the losses that led to the downfall of the British bank, Barings. These losses have served as a reminder that derivatives markets, useful as they are as risk management tools, are a source potential of risk for all those who deal in them if they are not carefully monitored, controlled and managed.[9]

7.14 The Treasury in its submission, acknowledged these problems. It noted that increasing complexity and uncertainty in the market had led to an inability on the part of investors to properly evaluate the risks inherent in their decisions:

> The recent crises have revealed shortcomings in the way investors and creditors have evaluated and priced the risk of their investment and lending decisions. In particular the absence of adequate, reliable and timely information is now widely accepted as one of the factors which exacerbated the severity of the East Asia financial crisis.
>
> The increasing sophistication and integration of financial markets over the last two decades, such as the growth of derivative markets, have compounded the difficulty faced by the market in addressing information requirements.[10]

8 Frank Partnoy, F.I.A.S.C.O., Blood in the Water on Wall Street, W.W.Norton & Co., New York, 1997, pp.55-57.

9 Sydney Futures Exchange Limited, *Surviving with Derivatives: What Directors Need to Know*, June 1995, p.1.

10 Submission No.13, The Treasury, p.2.

7.15 There are three areas which seem to be at the heart of most derivative-related difficulties:

- anything which can be used to reduce risk can, if misused, increase that risk;
- the inclusion of a leverage provision in derivative contracts multiplies the impact of market changes. Not all of these risks are revealed in public accounting records; and
- complexity – there is a constant need for users of derivatives to keep up-to-date with the latest products and techniques. If they do not, they are dependent on the skills and integrity of the traders selling the product.[11]

7.16 The problem of evaluating risk in connection with derivatives was brought out by the Association of Superannuation Funds of Australia. The Association commented that it is difficult to determine the real extent of exposure to market fluctuations when derivatives are used:

> It comes back to the nature of some of the derivative instruments and a matter of pricing them. The exposures through derivatives can be more problematic to report on a continuous basis because their value is contingent on developments. You may have a very small exposure, given a certain level of pricing in either a currency or a commodity, but if there are adverse developments, that exposure can change.[12]

7.17 The trend towards more and more complicated derivatives is likely to continue. When this likelihood is combined with the growing body of evidence showing that investors are often not fully aware of what they are buying, it is clear that there is a need for more transparency in this area. The literature indicates that many of the instances of huge losses by investors could have been avoided if they had been clearly aware of the nature of the product offered to them.

7.18 Treasury, however, sounded a cautionary note when it commented that since the use of derivatives tended to shift transaction risk to those more able to bear it, the increase in derivatives use is likely to help stabilise the international finance system rather than destabilise it.[13]

7.19 The SFX in its guide to Directors on derivatives, added similar comments:

> Every academic study, and an exhaustive US Government inquiry conducted by the Brady Commission after the stock crash of 1987, has concluded … : that futures and other derivative markets provide a safety valve in the event of a financial crisis; they are an escape hatch that allows fund managers to adjust their exposure to

11 Intellishare, *Derivatives Primer*, 28 June 1999, p.5. http://www.intellishare.com/derivtxt.htm

12 Evidence, Association of Superannuation Funds of Australia, 22 March 2000, p.110.

13 Submission No. 13, The Treasury, p.15.

a rapidly moving market. Without them the crash of 1987 would almost certainly have been much worse.[14]

7.20 The solution would therefore seem to lie in greater transparency in the derivatives trade. If traders were required to disclose complete information about their product, many of the current problems would be eliminated.

Size of the derivatives market

7.21 The growth in international financial transactions in the last twenty years has been extraordinary. The Treasury, referring to a study by the McKinsey Global Institute, observed that the stock of all financial assets traded on global markets increased from an estimated $US 5,000 billion in 1980, to $US 35,000 billion in 1992. It is expected to reach about $US 83,000 billion this year. To put these totals in perspective, the 1992 total is equivalent to twice the GDP of the OECD countries at the time and the projection for 2000 would be three times the OECD's GDP.[15]

7.22 In this rapid increase in transactions, the fastest growing products have been interest rate and currency derivatives. These two now make up 98% of the total.[16] The following table, provided by the Treasury[17], covering a selected range of derivatives, gives a guide to the rate of growth in the use of derivative instruments:

Table 2: Selected Financial Derivatives Markets ($US billion, notional amounts outstanding at year end)

Instruments	1986	1988	1990	1992	1998
Exchange Traded Instruments	**583**	**1307**	2292	**4641**	**13549**
Interest rate options and futures	516	1175	2054	4288	12305
Currency options and futures	49	60	72	105	57
Stock index options and futures	18	72	166	248	1186
Over-The-Counter Instruments	**500**	**1330**	**3451**	**5346**	**50997**
Interest rate swaps	400	1010	2312	3851	--
Currency and interest/currency	100	320	578	860	--
Other	--	--	561	635	--
Total	**1083**	**2637**	**5743**	**9987**	**64546**

Source: Bank of International Settlements Annual Reports, various.

14 Sydney Futures Exchange Limited, *Surviving with Derivatives: What Directors Need to Know*, June 1995, p.11.

15 Submission No. 13, The Treasury, p.14.

16 Submission No. 13, The Treasury, p.14.

17 Submission No. 13, The Treasury, p.15.

7.23 The Treasury reported that the 'notional value' of outstanding contracts in 1995 amounted to about $US 57 trillion and by 1998 it was around $US 86 trillion. These figures were qualified by the explanation that the 'notional principal values' quoted represent the face value of the contracts. If there is an adverse change in the value of a derivative, it is usually only a fraction of the face value which is subject to a 'margin call'[18], not the full amount:

> Thus the actual international financial flows, the credit exposure, and the money at risk in these derivative contracts, is typically only a few per cent of the 'notional principal' value.[19]

7.24 Even at a few per cent of the notional principle value, however, the total amount of money involved is still huge. It should also be remembered that it was failure to meet margin calls for that small percentage of their debt which brought down Barings Bank and Long Term Capital Management.

Hedging and speculating with derivatives

Hedging

7.25 Hedging is simply the process of preventing or minimising loss by compensating in one market for potential losses in another. It is used as an insurance technique, seeking protection against future price fluctuations. It is commonly used as protection against fluctuations in currency exchange rates or commodity prices.[20]

7.26 There are many different ways in which hedging can be undertaken. A simple example is when a trader wishes to enter into a contract to sell currency at the current (or spot) rate at a specified date in the future. This insures him against any fall in the currency in the meantime – it also means, of course, that he forfeits any profit should the currency rise. It is, however, possible for him to use an options contract. This gives him the

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18 Each buyer and seller must maintain a margin account with their brokerage firm or exchange clearing house. The deposit in this account is known as the 'initial margin. Each day when a trader's transactions are balanced, any loss sustained is deducted from the margin account. If that account falls below the 'minimum maintenance margin', the trader will receive a 'margin call' to restore the minimum margin. [Summarised from *Reuters Glossary of International Financial and Economic Terms*, Third Edition, 1994.]

19 Submission No. 13, The Treasury, p.15.

20 Edna Carew and Will Slatyer, *FOREX: The Techniques of Foreign Exchange*, Allen & Unwin, Sydney, 1989, p.124.

same arrangement but with an option over whether or not he chooses to complete the contract when the specified day arrives.

7.27 A second example is a swap arrangement. If a trader has too much of his debt in contracts with flexible exchange rates, he may choose to swap some of those contracts for others carrying a fixed exchange rate. He has then ensured that if interest rates increase, his loss has been minimised. Similar arrangements are often entered into using swaps between various currencies.

7.28 Hedging arrangements are very flexible and transactions may be hedged and then unhedged a number of times – depending on how high the trader judges the risk factor to be.

Speculating

7.29 The Reuters Glossary defines speculation as:

> The act of taking a … position in the market in anticipation of a favourable move, which should result in a gain when the position is covered. Also refers to investors' general belief that a certain specific event may occur.[21]

7.30 Speculative investments can be distinguished from hedged investments in that they are not linked to a commercial transaction. They are normally made on a short-term basis and carry an above-average risk level. To offset that increased risk level, the returns are also high if the investment is successful.

7.31 In currency markets, large scale speculation can be dangerous to the stability of the market. The Reserve Bank's submission, referring to the activities of hedge funds at the beginning of the Asian Crisis, said:

> In fact, some might regard the actions of hedge funds … as the ultimate in destabilising behaviour: they came into a market that was already under intense pressure and sold a large volume, pushing the currency over the brink.[22]

7.32 Similar activities by the hedge funds in the UK in 1992 and Australia in 1998, underline the dangers posed by the rapid movement of large scale speculative investment flows.[23]

7.33 The Reserve Bank made it clear that firms simply positioning themselves to take advantage of anticipated market developments are carrying out a

21 Reuters Limited, *Reuters Glossary of International Financial and Economic Terms*, Edited by the Senior Staff of Reuters Limited, 3rd Edition, Longman Group Limited, Essex, UK, 1994, p.118.

22 Submission No.7, Reserve Bank of Australia, p.3.

23 Submission No.7, Reserve Bank of Australia, pp.1, 3-4.

perfectly legitimate business activity. The problems arise when that firm (or firms) tries to influence the course of those developments. The Reserve Bank, referring again to hedge funds commented:

> Their ability to do this reflects not only the size of their position-taking relative to some of the markets in which they operate, but their influence on the behaviour of other market participants because of the reputation they enjoy.[24]

Conclusions

7.34 In relation to derivatives, the Committee noted that the solution to many of the problems lies with the participants themselves – making sure that they fully understand the financial instruments they are buying; insisting on receiving complete information before they proceed and ensuring that their risk level is contained within feasible limits.

7.35 Government could assist this process, the Committee said, by requiring greater disclosure from traders offering complex products. The general issue of greater disclosure was addressed directly by the Committee in the chapter on Transparency and Information Requirements (Chapter 4).

7.36 The main issue of concern to the Committee is the problem of the unregulated, tailor-made for the client product, which stands outside the present legislative requirements. The Committee said that it is difficult to see how these products could be regulated when they are never involved in the regulated sectors of the market. In fact, many of them are deliberately designed to *ensure* that they are not subject to prudential regulation.

7.37 The Committee considers that the rapid changes occurring in the area of international financial markets suggest that the whole subject should be addressed again in the next Parliament.

24 Submission No.7, Reserve Bank of Australia, p.2.

Recommendation 7

7.38 **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.

David Hawker MP
Chair
1 March 2001

A

Appendix A - List of Submissions

Submission No.	Individual/Organisation
1	Mr Ian Bowie
2	Mr Laurence Kennedy
3	Dr Carolyn Currie
4	Financial Planning Association of Australia Limited
5	Association of Superannuation Funds of Australia Limited
6	Australian Stock Exchange Limited
7	Reserve Bank of Australia
8	Australian Securities and Investments Commission
9	Sydney Futures Exchange
10	Results Australia
11	Australian Bureau of Statistics
12	Department of Finance and Administration
13	Department of the Treasury
14	Dr Carolyn Currie (Supplementary Submission)
15	Investment and Financial Services Association Limited
16	Association of Superannuation Funds of Australia Limited (Supplementary Submission)
17	The Treasury (Supplementary Submission)
18	The Treasury (Australian Taxation Office) (Supplementary Submission)

B

Appendix B – List of Exhibits

Exhibit No.	Description
1	Currie, C. 1999. *The need for a supra-mega regulator for the next millennium – is there evidence?* University of Technology Sydney. Provided by Dr Carolyn Currie.
3	Rizzuto, D. 1999. *Trade in financial derivatives' effect upon trade in other goods and services.* Provided by Mr Dale Rizzuto.
4	Reserve Bank of Australia. 1999. *Hedge Funds, Financial Stability and Market Integrity.* Provided by the Reserve Bank of Australia.
5	Australian Bureau of Statistics. March, 1999. *Financial Accounts.* Provided by Australian Bureau of Statistics.
6	CONFIDENTIAL
7	Table of *Membership of International Forums*; and Table of *Financial Stability Forum Working Groups.* Provided by the Reserve Bank of Australia.
8	Table of *Australian and US Cash Rates*; and Table of *Spread between Australian and US Cash Rates.* Provided by the Reserve Bank of Australia.
9	Investments and Financial Services Association Standards

C

Appendix C - List of Hearings and Witnesses

Wednesday, 9 February 2000

Australian Stock Exchange

Mr Jason Anderson, Senior Economist

Mr Michael Roche, Executive General Manager, strategic Planning, Marketing and Corporate Relations

Reserve Bank of Australia

Mr Ric Battellino, Assistant Governor (Financial Markets)

Mr Ian Macfarlane, Governor

Dr Stephen Grenville, Deputy Governor

Sydney Futures Exchange

Mr Malcolm Starr, Director, Legal and Compliance

Individual

Dr Carolyn Currie

Monday, 13 March 2000

Department of Finance and Administration

Mr Michael Carnahan, Branch Manager, Long Term Budget Policy Unit

Mr John Cassidy, Manager, Commonwealth Authorities and Companies Unit, Financial Framework Branch

Mr Philip Hagen, Accounting Centre

Mr Neville Jackson, Director, Accounting and Governance

Mr Edward Lekawski, Economic Adviser, Long Term Budget Policy Unit

Treasury

Dr Kenneth Henry, Executive Director, Economic Group

Dr James Horne, Macroeconomic Policy Division

Mr Gary Johnston, Chief Adviser, International

Mr Terrence O'Brien, Specialist Adviser, APEC

Dr Paul O'Mara, Specialist Adviser, Forecasting

Ms Karen Spindler, General Manager, International Finance Division

Wednesday, 22 March 2000

Association of Superannuation Funds of Australia

Mr Ross Clarke, Principal Researcher

Ms Phillippa Smith, Chief Executive Officer

Australian Securities and Investments Commission

Mr M Rogers, Director, Regulatory Policy

Mr Andrew Larcos, Government Relations Officer

Ms Rose Webb, Office of International Relations

Investment and Financial Services Association

Mr Richard Gilbert, Deputy Chief Executive Officer

Mr Gerald Naughton, Member, Collective Investment Vehicles Committee Task Force; Senior Investment Manager, AMP Asset Management

Individual

Dr John Edwards

Thursday, 13 April 2000 - Canberra

Australian Taxation Office

Mr David Grecian, Assistant Commissioner, International Tax Division

Treasury

Dr Kenneth Henry, Executive Director, Economic Group

Mr Bruce Paine, General Manager, Business Entities and International Tax Division

D

Appendix D - Round Table Conference with Members of the Finance Community

Sydney, 9 November 2000

Members of the Committee and the following:

Mr John Rappell	Australian Financial Markets Association
Professor Mike Aitkin	Professor of Finance, Sydney University
Mr Jason Anderson	Australian Stock Exchange
Mr David Brocklehurst	Reuters
Professor Doug Foster	Australian Graduate School of Management, University of NSW
Mr Richard Gilbert	Investment and Financial Services Association Ltd
Mr Nigel Hale	INVESCO Asset Management Limited
Dr David Lynch	International Banks and Securities Association