



**Review of the  
Reserve Bank of Australia  
Annual Report 1997-98  
Interim Report**

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

February 1999

## Review of the Reserve Bank of Australia annual report 1997-98 Interim report

*Australia, in case you didn't know, is the miracle economy of the world financial crisis. Although most of its exports go either to Japan or to the stricken tigers, Australia has weathered the storm. The key to this has been its policy of benign neglect toward the exchange rate. Instead of raising interest rates to defend the Aussie dollar - which would also have slowed the Aussie economy - the central bank allowed the currency to slide, from almost 80 US cents in early 1997 to the low 60s by mid-1998. The result was that while export prices plunged in US dollars, they held up in local currency, and strong domestic demand kept the economy humming.*

Krugman, P, Professor of Economics, Massachusetts Institute of Technology. First: A failed conspiracy: I know what the hedgies did last summer. *Fortune*, vol 138 (12), 21 December 1998, p 22.

The Parliament of the Commonwealth of Australia

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## FOREWORD

In this the first report of the Committee in this parliament we deal with the December public hearing with the Reserve Bank of Australia and the Bank's associated November 1998 semi-annual statement on monetary policy. The public hearing was one of the Committee's bi-annual meetings with the Governor of the Reserve Bank that have become an important component of the Committee's work and the Bank's public accountability strategy.

As a result of this scrutiny process the parliament, financial sector and community have an excellent opportunity to monitor the way in which the Bank conducts its activities and monetary policy. Interest in the process continues to grow.

The benefits of the openness and accountability of the Australian financial system have been clearly demonstrated during the Asian financial crisis.

In comparison with many other countries in Asia and the Pacific Rim, the Australian economy has performed a lot better during the Asian crisis. Australia's growth rate has been relatively high at 4% without upwards pressure from inflation. This is in part attributable to the astute performance of the Reserve Bank on the exchange rate. The Bank's steady, deliberate approach to monetary policy has paid off. However, as the Bank has stressed, this better than expected economic performance should not lead to complacency - the crisis is still far from over. The Committee will continue to monitor progress on these issues at its May 1999 public hearing with the Bank.

In undertaking this scrutiny work the Committee appreciates the assistance and cooperation it received from Ian Macfarlane, Stephen Grenville, Glenn Stevens and their staff. The professionalism of the Bank's management and staff was clearly reflected in the Bank's approach to the public hearing and in the contents of its semi-annual statement.

The Committee also appreciates the briefings it received prior to the hearing from the Chief Economists, Dr Chris Caton and Mr Saul Eslake, of Bankers' Trust and ANZ Bank, respectively.

In conclusion, I thank all members of the Economics, Finance and Public Administration Committee for their contributions to the public hearing and to this report.

David Hawker MP  
Chairman





## **MEMBERS OF THE COMMITTEE**

**Chairman** Mr D P M Hawker MP

**Deputy Chairman** Mr G S Wilton MP

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Dr A J Southcott MP

**Secretary** Mr C Paterson

**Inquiry Secretary** Ms B Forbes

**Adviser** Mr D Richardson

**Inquiry Staff** Ms B Zolotto



## **TERMS OF REFERENCE**

The Standing Committee on Economics, Finance and Public Administration is empowered to inquire into and report on any matter referred to it by either the House or a Minister, including any pre-legislation proposal, bill, motion, petition, vote or expenditure, other financial matter, report or paper.

Annual reports of government departments and authorities tabled in the House stand referred to the relevant committee for any inquiry the committee may wish to make. Reports stand referred to committees in accordance with a schedule tabled by the Speaker to record the areas of responsibility of each committee.

The *Reserve Bank of Australia annual report 1997-98* was tabled in the House of Representatives on 11 November 1998.



## **ACRONYMS AND ABBREVIATIONS**

APRA	Australian Prudential Regulation Authority
ACCC	Australian Competition and Consumer Commission
CAD	Current account deficit
CPA	Commonwealth Public Account
EMU	European Monetary Union
RBA	Reserve Bank of Australia
RTGS	Real-time gross settlement



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# CHAPTER ONE

## INTRODUCTION

### Background

1.1 The common understanding between the Treasurer and the Governor of the Reserve Bank of Australia (RBA) on key aspects of Australia's monetary policy framework is now well established and operating very effectively. It has been formally in operation now for over two years and for some years on an informal basis before that time. This includes the popular appearances of the Governor before the House of Representatives Standing Committee on Economics, Finance and Public Administration twice each year (May and November) to report on the conduct of monetary policy.

1.2 At the basis of the Committee's review of the Reserve Bank are the Bank's semi-annual statements on the conduct of monetary policy and its annual reports. The former arises from the Bank's decision to table the semi-annual statement as part of this accountability process. The basis for the annual report review is House of Representatives' standing order 324 (b) whereby annual reports within a committee's area of portfolio responsibility stand referred for any inquiry the committee may wish to make (see terms of reference at page xi).

1.3 All participants agree that this process has been an important avenue of accountability and transparency for the RBA and has provided the parliament, financial sector and community, with valuable insights into the way in which the RBA conducts its activities and monetary policy and the basis for its decisions.

1.4 This work by the Committee on the Reserve Bank is part of the Committee's broader program for reviewing the annual reports of several agencies in the financial services and public sectors.

### Scope and conduct of the review

1.5 At its meeting on 10 December 1998 the Committee resolved to examine the Reserve Bank of Australia's annual report 1997-98 and the November 1998 semi-annual statement.<sup>1</sup>

1.6 This report focuses on those two documents both of which were discussed at a public hearing in Canberra on 15 December 1998. Details of that hearing are set out at Appendix 2. Unlike previous hearings when the Bank released its semi-annual statement at the public hearing, on this occasion, due to the timing of the 1998 federal

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1 *Reserve Bank of Australia report and financial statements 30 June 1998*. Sydney, RBA, 103p; and Reserve Bank of Australia. 1998. *Semi-annual statement on monetary policy, November 1998*. Sydney, RBA, 48p.

election and the return of the parliament, the Bank released its statement in November, some five weeks prior to the hearing. This gave the Committee and others the opportunity to consider the November statement in more detail. Despite this gap the Governor advised that the '...statement still represents a reasonable summary of our views on events that have taken place over the preceding six months...'<sup>2</sup> A copy of the transcript of evidence from the hearing has been published by the Committee and is available from its secretariat and on the Committee's internet site<sup>3</sup>. Copies of the November statement are available from the Reserve Bank and on its internet site<sup>4</sup>.

1.7 The Committee's review clearly is a public process. However, it is not as comprehensive as an inquiry into a specific reference, since the review is not formally advertised in the press, and submissions generally are sought only from those organisations directly involved in the review process.

1.8 Prior to the December hearing, the Committee continued the practice of its predecessors of holding private briefings with two leading economists from the financial sector. On this occasion the economists were Mr Chris Caton, Executive Vice President, Client Business Group (Chief Economist), Bankers' Trust and Mr Saul Eslake, Chief Economist, ANZ. Those briefings presented alternative views on some aspects of monetary policy, the Australian economy and the international outlook.

1.9 In undertaking its review the Committee examined monetary policy, some other aspects of the operation of the Bank and the new division of financial responsibilities between the Bank and other agencies. This report focuses on all three matters as well as international developments affecting the Australian economy. In addressing monetary policy the Committee has not repeated the detail of the Bank's views as set out in the November 1998 semi-annual statement, rather it has highlighted a number of significant matters that were raised at the public hearing, some of which were also discussed in the semi-annual statement.

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2 Evidence p 2.

3 <http://www.aph.gov.au/hansard/rep/commtee/r2018.pdf>

4 [http://www.rba.gov.au/bulletin/bu\\_nov98/semi\\_annual\\_1198.pdf](http://www.rba.gov.au/bulletin/bu_nov98/semi_annual_1198.pdf)



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## CHAPTER TWO

# CONDUCT OF MONETARY POLICY AND FINANCIAL SYSTEM STABILITY

### Conduct of monetary policy

#### *Review of forecasts presented in May 1998*

2.1 As has been past practice, the starting point for discussion with the Governor was him being accountable for what he had said in his evidence to the Committee at the previous public hearing and in his related semi-annual statement.

2.2 At the May 1998 hearing the Governor summarised the outlook for the rest of 1998 as follows: GDP to grow at about 3%; unemployment rate to remain relatively stable; inflation to reach about 2% by the end of the year; and the current account deficit (CAD) to average 5.5% in 1998.<sup>1</sup> He thought '...this combination of events would be a reasonably good result for Australia in view of the difficult external situation we were facing, particularly among our Asian export markets'.<sup>2</sup>

2.3 Actual results during 1998 were: GDP growth about 4% (up from the expected 3%); unemployment continued to edge down rather than staying flat (7.9% in the last quarter of 1998 compared with 8.1% in the first quarter of that year); the inflation trough had passed and in round figures for the four quarters to December 1998 is still expected to be about 2%; and the CAD is expected to average 5% (rather than the 5.5% expected).<sup>3</sup>

2.4 Reflecting back on his May 1998 expectations the Governor noted:

In the event, the external situation did not get any better, but Australia's economic performance has exceeded our expectations and, to the best of my knowledge, the expectations of virtually all forecasters...

I would summarise the situation as being one where the forecast errors were within the normal ranges that occur with forecasts of this type...<sup>4</sup>

He emphasised this latter point again during the hearing.<sup>5</sup> The Committee notes this explanation.

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1 Evidence p 2 and see also House of Representatives Standing Committee on Financial Institutions and Public Administration. June 1998. *Review of the Reserve Bank of Australia annual report 1996-97*. Canberra, House of Representatives Printing Service, pp 6-8.

2 Evidence p 2.

3 Evidence pp 2-3.

4 Evidence pp 2-3.

5 Evidence pp 30-31.

2.5 Obviously, the Committee also is pleased with the better than expected result of the good economic outcomes over the past year. This was a recurring theme during the hearing discussions and in the semi-annual statement.

2.6 On 2 December 1998, just prior to the hearing, the Bank made a further easing of monetary policy by reducing interest rates by a quarter of a percentage point to 4.75%. The Bank said '...even though most of the data coming in was still suggesting good growth, the likelihood was that growth would decline in 1999 and, at the same time, the likelihood of overshooting the inflation target was judged to have declined...'<sup>6</sup>

2.7 It described this as '...a very thoughtful, premeditated, precautionary step...'<sup>7</sup> This reflects the general approach that the Bank is taking to monetary policy at this time.

2.8 In response to a question on the timing of that interest rate change after months of speculation and knowing the growth figures were to be released two hours later, the Bank explained that it chose that time because it wanted some time to distil the trend from the volatility in the international market. More generally, it noted that with such a small change in interest rates it makes little difference to the economy whether the change is implemented in a particular month or the next. While it is a big event for the financial markets, it is not for the economy as a whole.<sup>8</sup>

#### *Australia's success*

2.9 The Bank also gave its explanation of why Australia had performed better than most other countries in Asia or the Pacific Rim during the Asian crisis, that is, with a growth rate of over 4% over the past two years and without significant upward pressure from inflation which averaged 1.6% over the same period. The Governor stressed that the factors he outlined were in no particular order and were intertwined.<sup>9</sup> The factors he listed were:

- The Asian crisis hit at a time when the Australian economy was in good shape, partly for cyclical reasons;
- The economy benefited substantially from the flexibility of Australian exporters who switched from the contracting Asian markets into expanding North American and European markets and other markets not usually thought of as important to Australia. The commodities nature of much of Australian exports also assisted. It is global growth rather than regional growth in trading partners that is of most importance<sup>10</sup>;

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6 Evidence p 2.

7 Evidence p 7.

8 Evidence p 12.

9 Evidence pp 4-5.

10 Evidence pp 14-15.

- The greatly improved perception of the soundness of Australia's economic policies, for example the budget back in surplus where it should be in the mature phase of economic expansion; nearly a decade of low inflation; good financial infrastructure including well regulated banks, other financial institutions and stock exchanges; and an underlying body of commercial law and accounting practice at or close to world best practice. In addition, Australia has more confidence in itself, for example while business confidence initially fell in response to the crisis, it did not fall excessively and in the past three months it has tended to rise moderately again as data on the state of the economy confirmed the economy has performed better than expected;
- The economy is now more flexible and adaptable than previously, as demonstrated by productivity increasing faster during the 1990s than in earlier decades. The Bank said this suggests that the painful changes of the past decade or so are paying off; and
- In response to a contractionary external shock the Australian dollar was allowed to float down. He said he, and most other commentators, viewed this factor as extremely important. He noted that the domestic economy had benefited from a lower exchange rate because exporters' incomes have been held up and the incentive to export has been maintained while at the same time assisting those industries that are competing against imports. He also noted that the domestic economy has benefited from not having to raise interest rates in order to maintain external parity (as needed if the exchange rate was fixed) nor to prop up a floating exchange rate that threatened to fall so far as to have undesirable inflationary consequences.

2.10 On the last point he stated that the Bank has been able to accept the continuation of high growth and a depreciating exchange rate without having to tighten monetary policy, and in fact easing it slightly in December by 0.25%, because these factors had not seriously threatened the inflation target. The Bank considers that:

...we are beginning to receive the big dividend that low inflation provides.

The economy has gradually adjusted to nearly a decade of low inflation and, although the adjustment is still not complete, the benefits are becoming apparent...

...the low inflation environment makes the task of monetary management a lot easier.<sup>11</sup>

2.11 The Bank advised that inflationary expectations are much lower and more stable, wage contracts are now often of two to three years duration, loans (including housing mortgages) often have fixed rates for as long as five years, and businesses

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11 Evidence p 6.

know they can no longer automatically pass on any cost increase which could get lost with other price increases.<sup>12</sup>

2.12 The Bank also noted that while consumers' inflation expectations, as indicated by the Melbourne Institute's survey, are at 3.5% or sometimes 4%, the economy does not pay a huge cost for that and there is not much the Bank can do about it. It expects people will eventually adjust to the low inflation level and the likelihood of it staying low. The Bank said that the area where this matters most is in wage bargaining and significant adjustments have been made in that area.<sup>13</sup> The Committee is pleased that wage pressures have eased over the past year, including executive pay which was a matter of considerable concern to the Committee at previous hearings.

2.13 On exchange rate volatility, the Bank stated that the exchange rate has stayed at about the same level of stability, but the underlying factors in the economy that should explain movements in the exchange rate have become more stable in the 1990s.<sup>14</sup>

2.14 The Reserve Bank's astute performance during the financial crisis is well recognised by economic commentators. For example, in a recent article Professor Paul Krugman stated:

Australia, in case you didn't know, is the miracle economy of the world financial crisis. Although most of its exports go either to Japan or to the stricken tigers, Australia has weathered the storm. The key to this has been its policy of benign neglect toward the exchange rate. Instead of raising interest rates to defend the Aussie dollar - which would also have slowed the Aussie economy - the central bank allowed the currency to slide, from almost 80 US cents in early 1997 to the low 60s by mid-1998. The result was that while export prices plunged in US dollars, they held up in local currency, and strong domestic demand kept the economy humming.<sup>15</sup>

2.15 The Committee also is impressed by the Bank's performance on this matter.

2.16 At the hearing the Governor went on to stress that the better than expected outcomes of the past two years should not lead to complacency. He pointed out that the Asian crisis is far from over. Evidence cited was the uncertainty of the US outlook, Japan remaining in the grip of powerful contractionary forces that could put continued downward pressure on commodity prices, and with the severity of the contractions in Asia that no one was expecting a quick or strong recovery.<sup>16</sup>

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12 Evidence p 6.

13 Evidence pp 12-13 and Reserve Bank of Australia. November 1998. *Semi-annual statement on monetary policy, November 1998*. Sydney, RBA, pp 43-45.

14 Evidence pp 11-12.

15 Krugman, P, Professor of Economics, Massachusetts Institute of Technology. First: A failed conspiracy: I know what the hedgies did last summer. *Fortune*, vol 138 (12), 21 December 1998, p 22.

16 Evidence p 6.

2.17 Not unexpectedly the Bank advised that over the past year it probably had spent more time looking at, and worrying about, the world economy than the domestic economy as the world economy was the more difficult to get a handle on and potentially the largest and most dangerous source of disturbances.<sup>17</sup> In the second half of 1998 the Bank said it looked very closely at the way in which the US economy was developing.<sup>18</sup>

2.18 When questioned again at this hearing about the arguments for and against having a monetary conditions index like some other countries have, the RBA said it saw no case for having one and reiterated comments it had made at previous hearings to support its views.<sup>19</sup>

2.19 At the hearing the Bank did not discuss details of the Asian crisis as it had reported on this issue in detail in its semi-annual statement and in a number of recent papers.<sup>20</sup> However, in response to questioning the Deputy Governor, Dr Grenville, explained the difficulties of forecasting the Asian crisis. He said: while the individual elements that were going wrong were recognised, the Bank had no idea that those elements would trigger off each other and become more powerful because they would interact and compound; while it was well known that banks in the crisis countries were fragile, there was no idea that they would fall apart now, it was equally likely that they would creep by this problem and after a while get better; there was no idea on timing; it is the interaction of these factors; and the long period of growth which coincided with these problems had impressed forecasters. He stated that it is a problem that is a lot clearer after the event.<sup>21</sup>

2.20 The Bank also advised that it is difficult to make generalisations about the risk of deflation in some Asian economies spreading further. It rejected the idea that the lasting legacy of the Asian crisis would be global deflation.<sup>22</sup> Given more recent developments on deflation, the Committee will pursue this matter in more detail at the next hearing.

#### *Australia's links with the US business cycle*

2.21 The Committee again raised questions about the links between the Australian and US business cycle.<sup>23</sup> The Bank advised that in the past the Australian business cycle and the US were so close that it is uncanny. This is one of the reasons the Bank

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17 Evidence pp 7-8.

18 Evidence p 8.

19 Evidence p 11.

20 Evidence p 6; *Semi-annual statement on monetary policy, November 1998*, op cit, pp 1-19; Macfarlane, IJ, Governor, RBA. November 1998. Recent international developments in perspective. *Talk to CEDA Annual General Meeting Dinner, Melbourne, 25 November 1998*, 8p; and Grenville, S, Deputy Governor, RBA. November 1998. Capital flows and crises. *Talk to Credit Suisse First Boston Australia Conference 'The global financial system - The risks of closure'*, Sydney, 13 November 1998, 22p.

21 Evidence p 31.

22 Evidence pp 31-32.

23 Evidence pp 6-9 and 15-16.

is so interested in the US economy having a soft landing. In looking ahead the Governor said the US's performance is still crucial to Australia. Despite some worries about the US economy from August to October 1998, the Bank's mainstream forecast is that they will have a soft landing.<sup>24</sup> However, concerns remain about the US share market now that the Dow is so high.<sup>25</sup> The Committee shares those concerns.

2.22 On links between Australian and US interest rates, the Bank said the pattern of Australian interest rates is not tied with the pattern in the US or any other country in particular. However, if a long run view of the world is taken, it is seen that inflation is going down and growth slowing and there is a downward trend in international interest rates. The Governor stated that while Australia shared that interest rate trend, it has not shared the month by month or quarter by quarter ups and downs.<sup>26</sup>

2.23 For example, in March 1997 the US Federal Reserve raised federal fund rates whereas in the same year in May and July the RBA lowered the cash rate. During the past three years while Canada, New Zealand and Britain went through a phase of raising interest rates and then lowering them, Australia's rates went down and then after a long pause went down further. To stress this further the Governor reminded the Committee that from July 1997 to August 1998 Australia ran its interest rates at half a basis point lower than the US interest rate for the first time in his career. He said '...That signified to me the fact that we have room to move and in a very different way from the US if circumstances are right.'<sup>27</sup>

2.24 In addition, the Bank also noted the stable asset prices situation in Australia relative to the US.<sup>28</sup>

#### *International involvements*

2.25 The Bank is involved with a number of international organisations including the IMF, OECD, Bank for International Settlements, and APEC. In commenting on the effectiveness of these organisations to address some of the financial problems recently encountered in the Asian region the Bank advised that: the past 18 months has not been a period of great achievement for international economic cooperation; there are a vast number of international organisations some of which are not meant to deal with a major economic crisis; and the Bank has increased its input to these organisations as a result of the crisis, sometimes taking a different stance to other members, most noticeably the western policy establishment of the US and the IMF.<sup>29</sup>

2.26 The Australian Government and the Bank have put the view that the international pressure to dismantle the remaining, and in many cases the quite minor

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24 Evidence pp 15-16.

25 Evidence p 16.

26 Evidence pp 6-7.

27 Evidence p 8.

28 Evidence p 10.

29 Evidence pp 24-26.

impediments to the free movement of international capital in some Asian countries, was a mistake. Some countries with very small and very fragile domestic financial systems were pushed to remove such impediments too early. As a result they were subject to massive movements in and out of international capital. The Bank would have preferred a transition phase.<sup>30</sup>

2.27 The Bank also advised that it was a member of the Prime Minister's Task Force on International Financial Reform. The Task Force reported<sup>31</sup> to the Prime Minister in December 1998. It '...identified a number of key principles and elements for reforming the international financial system so as to produce greater stability in capital flows, minimise the risk of future financial crises and provide a more effective mechanism for managing them when they occur...'<sup>32</sup>

2.28 The main elements include: improved transparency by corporations, governments and international financial institutions; all countries strengthening their standards for financial supervision and these should be subject to external surveillance; there should be supervision of highly leveraged hedge funds and large institutional investors; management of future crises could be improved with effective involvement of the private sector; trade finance should be maintained during a period of crisis management; national insolvency regimes need to be strengthened; and the composition of capital flows should be improved. The Task Force noted that Australia is well placed to make a significant contribution to the reform efforts. This undoubtedly includes a significant ongoing involvement by the Reserve Bank.

### *Hedge funds*

2.29 A new source of financial instability has been created by the establishment of hedge funds. These basically use borrowed money to bet on movements in financial prices. They bet on a particular currency or bond/stock price using hedge instruments, such as futures or options contracts. Hedge funds are mainly American and tend to escape regulation by setting up in the US as limited partnerships.

2.30 The Bank said these funds have become very large and intertwined with the major investment banks and commercial banks to the extent that last year the US Federal Reserve had to organise a rescue of one of them because the funds failure would have had systemic implications for the US and international economies.<sup>33</sup>

2.31 Little is known about these funds. However, the Bank reported that work by the Australian Prudential Regulation Authority (APRA) has revealed that Australian

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30 Evidence p 25.

31 Task Force on International Financial Reform. December 1998. *Report*. Canberra, AGPS, vii 113p.

32 Hon P Costello, MP, Treasurer. *Press release: Report of the Task Force on International Financial Reform*. 21 December 1998, p 1.

33 Evidence p 27 and see *Semi-annual statement on monetary policy, November 1998*, op cit, pp 13-14.

banks have exposure via lending and as the counterparty to a swap transaction, particularly a foreign currency swap transaction.<sup>34</sup>

2.32 At the hearing the Bank stressed the importance of:

- Finding out how large the hedge funds are (both on and off balance sheet);
- Banks reviewing their relationships with hedge funds which appear to have become quite incestuous; and
- Bringing hedge funds into the disclosure net and possibly the supervision net.

2.33 The Committee notes that there is: widespread support for action on those issues; similar matters were raised in report of the Task Force on International Financial Reform; the Bank of International Settlements has set up a group to examine these issues and the Reserve Bank is represented on that group.<sup>35</sup>

2.34 The Committee also strongly supports the implementation of the above suggestions and will follow progress on this matter with the Bank, APRA and in other forums.

2.35 In response to questioning on the Australian dollar being traded at something like 100 times the actual trade of Australia the Governor responded that 'The fact that there is a heavy turnover in the Australian dollar and in other currencies does not particularly disturb me because there has always been a very heavy turnover...'<sup>36</sup>

#### *Impact of tax reform on the economy*

2.36 The Committee asked the Governor for the Bank's views on the effect that tax reform is likely to have on the performance of the Australian economy. He responded that 'In the long run I think it has to have a good effect. We got ourselves into a situation where we have too narrow a tax base...So I think in the long run a tax reform to reduce that distortion has to be beneficial.'<sup>37</sup>

2.37 More specifically in commenting on the GST he stated that:

My understanding of the history of countries that have introduced a GST is that in the vast majority of cases there has been a once-off lift in prices, as the new post-tax prices are marked in, and that has fed on to a higher general rate of inflation. Remember that most of these GSTs were introduced in higher inflationary periods where that was more likely to occur. The ones that have been introduced most recently have been New Zealand, Canada and Japan, which were all introduced post the mid-

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34 Evidence p 30.

35 Evidence pp 26-27 and Task Force on International Financial Reform. December 1998. *Key findings*. p 4.

36 Evidence p 27.

37 Evidence p 16.



eighties. In my reading of those three cases, it was a once-off lift in the price level, and it did not get built into the underlying inflation.

...So that is the assumption that we would be working on.<sup>38</sup>

2.38 The Bank advised that it has not done any of its own modelling on the validity of the government's 1.9% inflationary impact and would probably not do anything like that until it knows the exact shape of the package.<sup>39</sup>

2.39 On the likelihood of a 100% pass-through of savings following the abolition of taxes like financial institutions duty and debits tax in the banking sector, the Bank said you would have to assume they would be passed on in full. However, it said it did not know the timing and that competition makes sure that happens but with some of these things competition takes a little longer to achieve the pass through.<sup>40</sup>

### *Unemployment*

2.40 Although unemployment is edging down, it is still too high.

2.41 In commenting on solutions to the unemployment problem, the Bank reiterated comments made at past hearings that while good monetary policy can make a contribution to getting the economy to wherever the appropriate level of structural unemployment is, macro-economic policies cannot return the economy to the levels of unemployment rates of the 1960s. Structural changes have to be made.<sup>41</sup>

2.42 The Bank believes that the proposal by the five economists<sup>42</sup> suggesting a real wage tax trade-off as a way of addressing unemployment problems should be taken seriously. It noted that many views are proffered on unemployment but few creative solutions are suggested. It said this proposal '...is about the most constructive thing that has come along in this area for years.'<sup>43</sup>

2.43 The Committee believes that unemployment remains such a significant issue that all proposals such as those from the five economists warrant further examination.

### *Prospects for 1999*

2.44 The Bank also provided its projections for 1998-99. Over the 1998-99 financial year the Bank expects growth rates to be between 2.5% and 3% (noticeably lower than over the past year); a resultant flattening out of the unemployment rate but at a slightly lower rate than formerly expected; inflation to be about 2.5% which is

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38 Evidence p 13.

39 Evidence p 17.

40 Evidence p 17.

41 Evidence pp 34-35.

42 Dawkins, Peter; Freebairn, John; Garnaut, Ross; Keating, Michael; and Richardson, Chris. Dear John: How to create more jobs. *The Australian*, 26 October 1998.

43 Evidence p 34.

consistent with the target; and some further widening of the CAD to about 5.5% but it would not be surprised to see a quarter or two of it running at over 6%.<sup>44</sup>

2.45 Given most forecasters have revised their estimates for growth of the world economy downwards (for example, the IMF revised its figures from 3.75% to 2.5% for 1999) the Bank expects the external environment for Australia will remain difficult and income from external sources will be constrained.<sup>45</sup>

2.46 Overall the Bank described its expectations for Australia as representing '...a good performance for an economy in its eighth year of expansion facing a difficult but not disastrous external environment...'<sup>46</sup> It also expects this situation to be well received by the domestic and international investment community.

2.47 The Committee continued to press the RBA on its now long standing promise of providing further information on national savings.<sup>47</sup>

#### *Changing views on monetary policy*

2.48 In September the Governor delivered a lecture on the development of monetary policy over the last quarter of the twentieth century.<sup>48</sup> The Committee raised questions from that lecture regarding the Bank's sensitivity to political controversies and the huge role played by inflation compared with employment in shaping our attitudes to monetary policy.

2.49 In response the Bank stated that when the issues of inflation targeting and central bank independence became recognised internationally as promising for monetary policy, these matters became polarised in the political arena in Australia. This situation has now turned around and there is considerable bilateral support for the arrangements currently in place such as the inflation target and the independence of the RBA as set out in the Act.<sup>49</sup>

2.50 During the past few years there have been other significant advances in the Bank's transparency such as detailed public announcements of changes in interest rates. The Bank said that in the past the standard central banking model was that the bank simply operated in the money market and if higher interest rates were required took some cash out. Interest rates would nudge up and the system relied on the market getting the message that the policy was now tighter. The Bank does not do

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44 Evidence p 3 and *Semi-annual statement on monetary policy, November 1998*, op cit, pp 2-3.

45 Evidence p 3.

46 Evidence p 3.

47 Evidence p 33.

48 Macfarlane, IJ, Governor, RBA. September 1998. Australian monetary policy in the last quarter of the twentieth century. Shann Memorial Lecture, Perth, University of Western Australia, 15 September 1988. in *RBA Bulletin*, October 1998, Sydney, RBA, pp 6-19.

49 Evidence pp 22-23.

that now. It said that on this issue Australia was a long way ahead of other major central banks.<sup>50</sup>

2.51 The Committee noted that the impact of announcing the recent smaller interest rate changes doesn't have as great an impact as announcing the larger rate changes that have occurred in the past. The Bank agreed.<sup>51</sup>

2.52 Questions were also raised about the meaning of 'steadiness in monetary policy settings' as emphasised in the semi-annual statement.<sup>52</sup> The Bank explained that it is combination of how many times the Bank moves interest rates and the perception that the Bank tries to build in the market place that it is not easily panicked by movements in the exchange rate or external factors that might impact on monetary policy settings. It said '...it is important that we do not do knee-jerk reactions, and it is important that the market understands that we do not do that. If you do not do those, it is likely...over a period of years that you will not actually make as many movements as some countries that do things more quickly...'<sup>53</sup> The Bank acknowledged that others hold the opposite view and it cannot prove which is the better way of proceeding. It prefers the deliberative approach.<sup>54</sup> The Committee supports the Bank's approach.

*Competition, interest rates, margins, fees and charges, and savings*

2.53 The Bank's view on the four pillars policy was also sought. It stated that this is a matter for APRA and the Australian Competition and Consumer Commission (ACCC). The Governor reiterated comments he had made on a previous occasion, that banking is just like any other industry and there is a body of competition law that applies. However, he did note that if the only choice was between four or two major banks, two would create the most concentrated banking system of a major country and he would probably prefer another country to try that first.<sup>55</sup>

2.54 The Bank believes that competition is having an effect on banks passing on cuts in interest rates. It said that while there was a period when it was drawing attention to the fact that the lag in passing on interest rate reductions was longer than the lag for interest rate rises, that is now changing.<sup>56</sup>

2.55 The Deputy Governor said that in preparing data on the lag the banks argue about exactly when is the critical moment to start to estimate the lag, that is, for the banks their cost of funds and the changes in that do not exactly correspond with the RBA's changes in the cash rate. Despite this the Bank provided the following figures.

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50 Evidence p 23.

51 Evidence p 24.

52 *Semi-annual statement on monetary policy, November 1998*, op cit, pp 2-3.

53 Evidence p 13.

54 Evidence pp 13-14.

55 Evidence p 20.

56 Evidence p 19.

Following the 2 December monetary policy easing, the average lag with which changes in variable-rate lending rates were passed on to existing borrowers was noticeably less than the average lag in the five easings of 1996-97...These lags [that is, from 2 December easing] were also shorter than in the tightening phase of 1994.<sup>57</sup>

These implementation lags are summarised at Table 2.1.

**Table 2.1: Implementation lags**

	<b>Average number of days between change in the cash rate and effective change for borrowers</b>		
	Tightenings 1994	Easings 1996-97	Easing 1998
Small business indicator	16	35	9
Large business indicator	16	21	5
Housing indicator	16	51	22

Source: RBA Submission p S1.

2.56 At past hearings the Committee has sought details from the Bank on interest rate margins and this committee and its predecessors have looked at this matter in considerable detail.<sup>58</sup> The Bank now publishes this data regularly.<sup>59</sup>

2.57 As there is strong concern in the community that fees are going up, the Committee asked the Bank to prepare a detailed history of changes in bank fees and charges over the past 20 years so some comparison can be made for the future.

2.58 The Bank responded that this is a very difficult issue. It reported that it has received a similar request from its Small Business Advisory Panel for details on fees associated with borrowing establishment charges. The Bank agreed to provide information to the Committee on fees and charges generally, particularly transaction fees.<sup>60</sup> The Committee looks forward to receiving that information as soon as possible and will discuss this matter again at the May 1999 hearing.

2.59 The Committee is seeking to look at the net effect of the lower interest rates and the higher fees and charges. Dr Grenville advised that '...even though fees have

57 RBA Submission p S1.

58 For example see: House of Representatives Standing Committee on Financial Institutions and Public Administration. June 1998, op cit, pp 12 and 14; and House of Representatives Standing Committee on Banking, Finance and Public Administration. August 1994. *Review of the Reserve Bank of Australia's 1992-93 annual report*. Canberra, AGPS, pp 5-17.

59 Evidence p 18.

60 Evidence p 19.

gone up in absolute terms, they have not risen nearly as much as that perception would imply as a percentage of the balance sheets of the banks...<sup>61</sup> Without doing a formal calculation on this, he said his guess would be that '...the cut in margins, which has been very significant over the last few years during the 1990s, would outweigh the rise in fees, particularly taking into account the fact that many people have the ability to shift from one product to another.'<sup>62</sup>

2.60 At the hearing the Committee noted that one area that does not seem to have experienced the same competition in interest rates is credit cards where rates have only dropped from about 16.2% two years ago to 15.1% more recently. The Bank stated that this is not its area of responsibility, but it is also surprised that those interest rates are so high.<sup>63</sup>

2.61 The Committee will take this matter up in future meetings with APRA and the ACCC. To address that and other issues with APRA in a timely manner, the Committee has requested a general reference from the Minister for Financial Services and Regulation to look at APRA rather than wait for the release of APRA's annual report in the second half of this year.

2.62 On the issue of a decline in household savings over the past two to three years, the Assistant Governor, Mr Stevens, outlined structural adjustment reasons for the decline and advised that if the decline continued the longer term impact would need to be looked at.<sup>64</sup> The Committee will monitor this issue at future hearings.

### *Euro currency*

2.63 At the beginning of 1999 eleven members of the European Monetary Union (EMU) launched the "euro," the Union's common currency. The euro will be legal tender in Belgium, Germany, Spain, France, Ireland, Italy, Luxembourg, the Netherlands, Austria, Portugal and Finland.

2.64 On 1 January 1999 all deposits in those countries automatically became euros at an exchange rate determined by the monetary authorities on the eve of the changeover. The euro coins will begin to circulate over the following two years and by 2002 notes and coins will fully convert to euros.

2.65 It is likely that the euro will soon feature as an important international currency. It will probably be used more than the sum of the individual currencies of EMU countries are presently used. On 1 January 1999 Australia's official holdings of deutschmarks, which make up approximately one third of Australia's reserves and are the only European currency Australia holds, automatically became euros.

2.66 The Bank had few views on the implications for Australia of the introduction of the euro. It noted that as a result of the withdrawal of other European currencies,

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61 Evidence p 18.

62 Evidence p 18.

63 Evidence p 21.

64 Evidence pp 35 and 38-39.

Australia would move from having the tenth most traded currency in the world to the fifth or sixth.<sup>65</sup>

2.67 The only concrete implication that the Bank has identified was that the opportunities for diversification of investment of assets in Europe will be reduced as a result of the euro single currency and some of this investment may come to Australia because the economic characteristics in Australia are very different from Europe.<sup>66</sup>

2.68 The Bank does not expect a material change in the variability of the Australian dollar as a result of the introduction of the euro.<sup>67</sup>

2.69 The Committee will continue to monitor developments on this issue at future hearings with the Bank.

### **The new division of financial responsibilities**

2.70 On 1 July 1998 the new structural financial system arrangements came into place with the establishment of APRA. Supervision of the banks was transferred to APRA leaving the Reserve Bank to '...focus more broadly on potential risks to system stability, on how these risks might be reduced without unduly discouraging financial efficiency and innovation, and on how the Bank should respond to financial disturbances...'<sup>68</sup>

2.71 In the second half of 1998 Memoranda of Understanding were developed between the Reserve Bank and APRA (on their respective responsibilities for promoting the stability of the Australian financial system) and between the Bank and the ACCC on their respective responsibilities on payments system access and competition.<sup>69</sup>

2.72 At the hearing the Bank reported that the new arrangements are working extremely well with the banking supervision section of the Bank physically moving to the new APRA headquarters late last year.<sup>70</sup> The Committee will seek both APRA's and the ACCC's views on the success of the transition in hearings with those organisations later this year.

2.73 The next step to complete the second stage of the reforms is to transfer regulatory responsibilities for building societies, credit unions and friendly societies

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65 Evidence pp 28-29.

66 Evidence pp 28-29.

67 Evidence p 29.

68 *Reserve Bank of Australia report and financial statements 1998*, op cit, pp 6-7.

69 Reserve Bank of Australia and the Australian Competition and Consumer Commission. Memorandum of understanding. Joint media release, 9 September 1998. and Reserve Bank of Australia and Australian Prudential Regulation Authority. Memorandum of understanding. Joint media release, 12 October 1998. in *RBA Bulletin*, October 1998. Sydney, RBA, pp 20-21 and 28-30.

70 Evidence p 32.

from the States and Territories to the Commonwealth. To this end, on 30 November 1998 the Prime Minister wrote to the Premiers and Chief Ministers seeking their support by year's end for a draft agreement to transfer those responsibilities.<sup>71</sup> This is expected to be implemented by July this year.

### **Payments system**

2.74 In its 1997-98 annual report the Bank stated:

The new financial regulatory structure gives the Reserve Bank formal responsibility for the safety and efficiency of the payments system in Australia. A Payments System Board has been established in the Bank to determine its payments system policy...The Board's task has been rendered easier by the successful implementation of Australia's RTGS [real-time gross settlement] system over the past year.<sup>72</sup>

2.75 The Bank also reported that its legislative responsibility for efficiency of the payments system is a world first for a central bank. The Bank now has an independent responsibility to assess the efficiency of the payments systems.<sup>73</sup>

2.76 Australia's RTGS system for high value payments commenced operation on 22 June 1998.

2.77 The Deputy Governor reported that there have not been any difficulties with this system so far and while the testing is not complete, it is running to schedule.<sup>74</sup> The Committee will continue to monitor developments.

### **Year 2000 problem**

2.78 The Committee again raised questions about the Year 2000 problem.

2.79 In its 1997-98 annual report the Bank: revealed that it has taken the Year 2000 issue seriously; said it has a detailed program with target dates for dealing with the matter; outlined areas of impact in the Bank's operations; reported that by December 1998 it should have reached the stage of testing its modified Year 2000 systems; and believed that although there is a good deal of work remaining to be done, it has a high degree of confidence that the objectives of its project will be achieved.<sup>75</sup>

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71 Hon J Hockey, MP, Minister for Financial Services and Regulation. *Press release: Government shows commitment to financial system reform*. 30 November 1998, 1p.

72 *Reserve Bank of Australia report and financial statements 30 June 1998*. 1998. Sydney, RBA, p 12.

73 *Reserve Bank of Australia report and financial statements 1998*, op cit, p 14.

74 Evidence p 38.

75 Evidence pp 36-37 and *Reserve Bank of Australia report and financial statements 1998*, op cit, pp 57-59.

2.80 In its annual report the Bank also stated that its total cost of the work related to its Year 2000 problem will reach nearly \$5 million. The bulk of the funds are for existing staff redeployed from other activities.<sup>76</sup>

2.81 In addition, the Bank is participating in an interbank working group on Year 2000 issues, which together with the Australian Payments Clearing Association, is coordinating a program of testing of each of the major payment streams. Aspects of that testing began in late 1998.

2.82 In line with the strong emphasis at the May hearing that the Bank placed on developing community understanding of the Year 2000 problem and developing community confidence that the banking system is appropriately addressing that problem, in August 1998 the Bank and APRA released a booklet *Year 2000 preparations in the Australian banking and financial system*.<sup>77</sup>

2.83 The booklet outlines measures being taken by banks operating in Australia to address the Year 2000 date change; APRA's approach to supervising these preparations; the role of other financial system regulators; preparations in the payments and securities settlement systems; the Bank's internal Year 2000 activities; and outlines the results of the Bank's second Year 2000 survey of the banks.

2.84 Significant matters highlighted in the booklet are that: the cost of preparing the banking sector has risen to \$1 billion - up \$400 million on the last official estimates; only \$300 million has been spent, leaving \$700 million in expense over the next 18 months (at the time of the release of the publication); about 2500 bank staff are working on the problem; banks believed that they would meet international Year 2000 targets; potential exposures of banks to poorly prepared customers could be substantial (estimates less than 10% of customers have assured their banks they will be ready for 2000).<sup>78</sup>

2.85 The Committee raised questions about whether the Bank will print extra banknotes to handle the anticipated increase in demand for cash on the eve of Year 2000. The Bank advised that it would have more stocks on hand. To achieve this it is printing more notes and not destroying old notes. While the Bank is not expecting generalised panic from the public to hold additional notes and coins, it will be fully prepared for a rational precautionary increase in the public's holding of notes and coins in case some ATMs might breakdown. The Bank considers it very important to have an educational campaign to try to counter any irrational fears in the community on this matter.<sup>79</sup>

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76 *Reserve Bank of Australia report and financial statements 1998*, op cit, p 59.

77 Reserve Bank of Australia and Australian Prudential Regulation Authority. July 1998. *Year 2000 preparations in the Australian banking and financial system*. Sydney, RBA, 28p.

78 Reserve Bank of Australia and the Australian Prudential Regulation Authority, op cit, pp 5 and 12-14.

79 Evidence pp 36-37.



2.86 The Bank also advised that it is looking very closely at whether there is a need for other precautionary steps such as making sure there is a hardcopy of every bank account in the country at that time.<sup>80</sup>

2.87 The Committee remains concerned about the readiness of the banks to pursue the Year 2000 problem and will follow up this matter with the Bank at the May hearing.

2.88 At the May 1998 hearing the Bank's then Deputy Governor, Mr Graeme Thompson, also outlined actions taken by other regulators in the financial system to address Year 2000 compliance. He stressed that 'When APRA becomes responsible for regulation of these industries it will carry forward vigorously the work on the Year 2000 problem which the existing agencies have initiated.'<sup>81</sup> The Committee will take this matter up with APRA at a hearing later this year.

### **Customer services (commercial operations)**

2.89 In the past there have been criticisms of the Bank's involvement in what has been described as commercial activities such as banking services for governments; registry services for the Commonwealth and some State government and overseas agencies; electronic settlement facilities for Commonwealth Government Securities (CGS) and other transactions using the Reserve Bank Information and Transfer System (RITS); and a bulk currency note-issue facility.

2.90 While the Bank always seemed to downplay this issue, in 1997 as part of the Commonwealth's National Competition Policy work the Commonwealth Competitive Neutrality Taskforce reviewed the RBA's activities to ensure they conform to the principles of competitive neutrality.<sup>82</sup>

2.91 In its 1997-98 annual report the Bank advised that as part of the above process it had looked at which of its services are contestable, that is, can also be provided by private sector organisations.<sup>83</sup> The Bank considers two core non-contestable functions are: the RTGS system and note issue. Provision of contestable services by the Bank is on a business unit basis to facilitate transparency and accountability. In 1997-98 revenues from contestable activities were \$43.1 million, compared with costs of \$36.8 million.

2.92 As a result of the competitive neutrality review the following agreements and changes have occurred.

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80 Evidence p 38.

81 House of Representatives Standing Committee on Financial Institutions and Public Administration, *op cit*, p 23.

82 *Commonwealth competitive neutrality guidelines for managers*. 1998. Canberra, AGPS, iv 38p.

83 *Reserve Bank of Australia report and financial statements 1998*, *op cit*, pp 44-53.

### 2.93 *Banking*

- In 1997-98 outsourcing of cheque-processing operations commenced, with the Commonwealth Bank of Australia being selected as the external service provider.
- It was agreed with the Commonwealth Treasury and the Department of Finance and Administration that the core account-keeping function, involving the conduct of the Commonwealth Public Account (CPA) and associated major accounts, is a non-contestable area of banking business. In 1998-99 it is intended to restructure the banking business to separate the core account-keeping functions associated with the CPA from the transactions-processing part of the banking business, which is one of the contestable services provided.
- The Bank is working closely with the Accrual Budgeting Project Group established by the Department of Finance and Administration on the introduction of accrual budgeting and to devolve responsibility for banking arrangements to individual budget-sector agencies to replace the present largely centralised administration of banking arrangements. In August 1998 the Minister for Finance and Administration announced that from July 1999 commercial banks will be able to tender for multi-million dollar banking of 23 federal government departments and 38 agencies under the changed arrangements.<sup>84</sup>
- Continuing devolution of banking responsibilities to individual State government agencies.

2.94 *Registry and settlement services* - these services include the issue, transfer and registration of securities, maintenance of ownership records, periodical payment of interest and the redemption of securities at maturity. Levels of service in this area are declining.

2.95 *Note issue* - this embraces the storage, and issue of new and reissuable notes; the processing of notes returned from circulation for quality control purposes; and research into and development of note designs and security features. In mid July 1998 a part of the note-issue function, specialised currency distribution service to individual bank branches in metropolitan areas, which had been in operation for more than 30 years, was terminated.

2.96 *Note Printing Australia* - on 1 July 1998 it became a corporatised unit, having previously operated as an autonomous division of the RBA.

2.97 At the hearing in commenting on transaction banking business for government, the Bank stated that policy sensitive aspects - the government's foreign exchange transactions - will continue to be done through the Bank. It also advised that '...The balances at the end of the day will be swept back to the Reserve Bank, even if another bank is doing the transaction during the day.'<sup>85</sup> This latter point is a

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84 Hon J Fahey, MP, Minister for Finance and Administration. *Media release: Government to open its transactional banking to competition*. 31 July 1998, 1p.

85 Evidence p 40.

contentious issue with some of the banks now in competition with the RBA for government banking business.

2.98 The Committee also queried the competitiveness of the note printing function and received feedback from the Bank on that function's positive performance.<sup>86</sup>

2.99 The Committee notes that at the hearing the Bank seemed fairly confident it would retain its big government department and agency customers when tendering for the federal government departments and agencies banking business commences in July this year. The Committee will continue to follow progress on this issue with the Bank at the May 1999 hearing. Prior to that date the Committee welcomes submissions from the banks and other financial institutions on this matter.

### **Management of the Bank: Corporate developments**

2.100 In its 1997-98 annual report the Bank outlined significant changes to its management arrangements.<sup>87</sup>

2.101 More specifically, the Bank stated that in keeping with a trend over the past 15 years, there was a further reduction in staff numbers in 1997-98, that is, a fall of 212 (excluding Note Printing Australia) and a 60% decline in staff over the past decade. \$29.7 million in redundancy payments were made, up from \$2.7 million in 1992-93.<sup>88</sup> At the hearing the Bank said its staff numbers had reduced much faster than those in the commercial banks.<sup>89</sup>

2.102 The Bank attributed the 1997-98 reductions to: outsourcing of cheque clearing, withdrawal of some specialised note-issuing activities and the closure of the Bank's branches in Darwin and Hobart. It noted the unsettling nature of technological changes for staff and their remarkable ability to handle these changes.<sup>90</sup>

2.103 On the transfer of 60 Reserve Bank staff who deal with banking supervision to APRA, the Bank advised that broadly speaking, those staff have not suffered any financial loss because of the change in working conditions.<sup>91</sup> This matter will be followed up with APRA.

David Hawker  
Chairman  
18 February 1999

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86 Evidence pp 40-41.

87 *Reserve Bank of Australia report and financial statements 1998*, op cit, pp 4-5 and 54-57.

88 *Reserve Bank of Australia report and financial statements 1998*, op cit, pp 55-56.

89 Evidence p 21.

90 *Reserve Bank of Australia report and financial statements 1998*, op cit, pp 5 and 54-55.

91 Evidence p 33.



## **APPENDIX 1**

### **LIST OF SUBMISSIONS**

- 1 Reserve Bank of Australia

## APPENDIX 2

### LIST OF EXHIBITS

- 1 Reserve Bank of Australia and the Australian Prudential Regulation Authority. July 1998. *Year 2000 preparations in the Australian banking and financial system*. Sydney, RBA, 28p.

## **APPENDIX 3**

### **LIST OF HEARINGS AND WITNESSES**

#### **Tuesday, 15 December 1998 - Canberra**

Reserve Bank of Australia

Dr Stephen Grenville, Deputy Governor

Mr Ian Macfarlane, Governor

Mr Glenn Stevens, Assistant Governor

#### **PRIVATE BRIEFINGS**

#### **Thursday, 10 December 1998 - Canberra**

Dr Christopher Caton, (Chief Economist), Executive Vice-President,  
Bankers' Trust

#### **Monday, 14 December 1998 - Canberra**

Mr Saul Eslake, Chief Economist, ANZ Bank