

INTERNATIONAL FINANCIAL CO-OPERATION

The three years since the Asian crisis began have seen a substantial push within the international community for reform of the international financial system. The problems in Asia (and in Eastern Europe and Latin America as well) not only damaged the growth performance of the countries directly affected, but had repercussions on major financial markets, and brought a recognition on the part of the international financial community that changes should occur in the so-called international financial architecture. The RBA believed that it should contribute as strongly as possible to this work, given the potential for major changes to the shape of international financial markets to emerge from the process. As a result, the RBA increased significantly the resources devoted to participating in the main global and regional initiatives aimed at improving the functioning of the international financial system. In this work, the RBA co-operates closely with other arms of government, such as the Treasury and the Department of Foreign Affairs and Trade.

The unfolding crisis not only highlighted specific deficiencies in policies, but also exposed shortcomings in the way international financial issues were handled by the world community - in the international forums where these issues are discussed, and where rules and procedures are developed. In essence, two main groupings carried these responsibilities: the G7, which consists of the world's seven largest developed countries (United States, Japan, Germany, France, United Kingdom, Italy

and Canada); and the IMF/World Bank, with around 180 members. The former was too narrow to carry out the necessary consultation and co-ordination among countries, while the latter was too large to allow decisive actions to deal with emerging problems.

The initial response of the international community was to set up the G22, an ad hoc group of 22 countries including those affected by the crisis. This group was able to make quick progress on a number of issues, but the feeling was that its membership was not balanced, with some claiming that Asian countries (which made up 10 of the 22) were over-represented.

In the event, that group has been replaced by two new international groupings, which seem to have a greater degree of permanence than the G22. The two groupings are the Financial Stability Forum and the G20.

FINANCIAL STABILITY FORUM

The Financial Stability Forum was established in early 1999 by the G7. The Forum includes the G7 countries themselves, the major international financial institutions and four other countries representing significant financial centres. Australia was chosen as a member of this latter group along with Hong Kong, the Netherlands and Singapore. Australia is represented in the Forum by the Governor. By covering all the world's major financial centres, the Financial Stability Forum is in a good position to promote international financial stability and co-operation through the formulation of consistent rules and procedures relating to financial institutions. It is expected that this will be its main focus.



Since its establishment, the Financial Stability Forum has produced a series of working group studies and reports on international capital flows, offshore financial centres, highly leveraged institutions (HLIs), deposit insurance and the implementation of international financial standards. The RBA participated in the working group on HLIs, and Australia (through the Treasury) participated in the task force on standards.

REPORT ON HIGHLY LEVERAGED INSTITUTIONS

The potentially damaging impact of HLI activities on the stability and dynamics of international financial markets has been an issue of particular concern over the past two years or so, and one which the RBA has consistently pressed in various international groups. The RBA therefore welcomed the Forum's report on HLIs and fully supports the recommendations.

The Report considered both the systemic issues raised by the near-collapse in 1998 of Long Term Capital Management, a large hedge fund, and the potential impact of HLIs on market dynamics in small and medium-sized open economies. In relation to issues of systemic stability, the Report focused on the "breakdown in counterparty credit and trading discipline" which allowed both a high degree of leverage and large, risky positions to be built. On the impact of HLIs on small and medium-sized economies, it concluded that HLIs may from time to time establish large and concentrated positions in medium-sized markets and "have the potential materially to influence market dynamics". It went on to say that "the size and duration of effects can be amplified through herding or other market participants

moving to the sidelines". The Report was also concerned about aggressive practices alleged in some countries, but there was no agreement on the scale of these practices, nor on the implications for market integrity.

Overall, the Report concluded that the issues raised merited "a concerted international policy response" and made a number of recommendations. These recommendations incorporated work undertaken by the Basel Committee on Banking Supervision and the International Organisation of Securities Commissions (IOSCO) and in many respects were similar to conclusions reached by the US President's Working Group on Financial Markets. Much of the focus was on the risk management practices of HLI counterparties and regulatory oversight of credit providers.

The report also recommended measures to improve disclosure by large unregulated hedge funds, development of market practices guidelines for participants in foreign exchange markets, improved financial market infrastructure (including collateral practices), and enhanced financial market surveillance, both national and international.

The RBA believes that these recommendations, when fully implemented, will adequately address the systemic stability issues posed by HLIs. They may also be sufficient to contain the potential problems which HLIs can pose for market dynamics, although this is less certain. In this regard, the RBA was pleased that the Report leaves open the possibility of taking further steps should they appear necessary in future.

The United States, which is the country out of which most HLLs operate, is pushing ahead with legislation which will give effect to many of these recommendations. The *Hedge Funds Disclosure Act (Baker Bill)* would require quarterly disclosure of risk taking and leverage by large hedge funds (those with capital in excess of US\$1 billion, or in a group of funds with assets greater than US\$3 billion). A second piece of legislation, the *Derivatives Reform Act of 1999 (Markey-Dorgan Bill)*, would enable the US Securities and Exchange Commission to obtain quarterly disclosure statements from non-bank over-the-counter derivatives dealers, and to issue Large Trader Reporting Rules, allowing the agency to monitor and report on the activities of hedge funds.

REPORT ON FINANCIAL STANDARDS

The Financial Stability Forum recognised at its inception the importance of economic and financial standards in promoting sound financial systems, and at an early stage set up a Compendium of Standards on its web site. More recently, the *Issues Paper of the Task Force on Implementation of Standards* was released, proposing a strategy for fostering the implementation of international standards.

As a step in this direction, the Forum identified a set of key standards, considered likely to make the greatest contribution to reducing vulnerabilities and strengthening the resilience of financial systems. This was intended to allow a more focused approach to the implementation of standards, although priorities will vary considerably between countries.

REPORT ON OFFSHORE FINANCIAL CENTRES

The Forum's report on offshore financial centres was followed by publication of a classification of offshore centres according to the Forum's perceived ranking of the quality of their regulation and their degree of co-operation with other regulators. The purpose of this publication was to encourage efforts to improve regulatory systems in these centres. Several countries in the Pacific region were identified as having scope for improvement.

GROUP OF TWENTY

The other new international group, the G20, was set up in late 1999 and consists of countries of systemic significance in terms of the world economy. As well as the G7, it includes Argentina, Australia, Brazil, People's Republic of China, India, Indonesia, Republic of Korea, Mexico, Russia, Saudi Arabia, South Africa and Turkey. The European Union, the IMF and the World Bank are also included in the Group. Australia is represented in this group by the Treasurer and the Governor. It is expected to have a somewhat broader agenda than the Financial Stability Forum, covering general issues relevant to the world economy.

Since its inception, the G20 has focused on three main issues: choices between exchange rate regimes; liability management by national authorities; and private sector involvement in crisis prevention and resolution. The RBA was asked to lead the discussion on the issues facing national authorities in choosing an exchange rate regime at a G20 meeting for deputies in March 2000. G20 Ministers and Governors will consider these issues further at a meeting later in 2000.



Assistant Governor Glenn Stevens chairing a session at an international conference in Hong Kong. Other participants (left to right): Bijan Aghevli, formerly of the IMF; former Japanese Vice Minister of Finance for International Affairs, Eisuke Sakakibara; and Professor Ronald McKinnon of Stanford University.

The role of the private sector in crisis prevention and resolution is also an issue on which the RBA has placed considerable importance in the past two years. Over this period there has been substantial progress in identifying the principles and possible tools which could be used to obtain appropriate private sector involvement. There remains much to be done, however, in spelling out how these tools can be applied in practice. While much of the practical application is likely to fall to the IMF, which is considering the issues at present, the RBA sees an important role for the G20 in providing a venue for continuing discussion of the issues as well as for review of the IMF's performance in achieving private sector involvement.

OTHER INTERNATIONAL GROUPS

In addition to these global groups, the RBA participates in a range of work with the Bank for International Settlements (BIS) and associated G10-based committees.

Here the RBA is currently involved in three main initiatives. The first is a Study Group set up by the Committee on the Global Financial System to investigate the possible effects of the growth in electronic trading on market dynamics. The second is a G10 Working Party studying the causes of financial sector consolidation and its consequences for competition and efficiency, monetary policy and financial system stability. The third involves work on payments and clearing systems through the Committee on Payment and Settlement Systems.

One project undertaken by the latter Committee during the year was development of a set of Core Principles for Systemically Important Payment Systems, to provide a set of reference points for countries reforming and

modernising their payment systems; this work was released for comment during the year and is expected to be finalised by end 2000. Another project involved oversight of work by private sector banks to establish a "continuous linked settlement" or CLS Bank, an initiative to reduce the risks associated with the settlement of foreign exchange transactions. A third project involved analysis of retail payment systems in the G10 countries and Australia; this is particularly relevant to the RBA given its statutory responsibility for the efficiency as well as the safety of Australia's payments system. Further details of these projects and other work on payments system policy issues can be found in the Annual Report of the Payments System Board, due to be released in October.

In addition, the Bank has remained an active participant in regional groups including:

- the Executives' Meeting of East Asia-Pacific Central Banks (EMEAP), consisting of eleven countries in the region. EMEAP has three permanent working groups: on financial markets (which the RBA chairs); on payment and settlement systems; and on banking supervision (on which both the RBA and APRA are represented);
- the Manila Framework Group, which consists of representatives of central banks and Ministries of Finance or Treasuries of twelve Asian countries plus the United States, Canada, and the international institutions;
- the Asia-Pacific Economic Cooperation Group (APEC); and
- the Four Markets and Six Markets Groups of major financial centres in the Asia-Pacific area.

With the exception of EMEAP, the Treasury is also a participant in the above regional groups.

A common theme that emerged in regional discussions over the past year or so was the need to stimulate development of bond markets in the Asian region. While countries such as Australia and Japan have highly developed markets, many other countries do not. This is seen as an obstacle to corporations raising finance, and as tending to skew the provision of finance towards the banking system. As the events of recent years showed, heavy concentration of financing through banks can make it difficult for corporations to raise funds when economic conditions deteriorate and banks subsequently adopt more cautious lending policies and cut back their provision of credit.

While these issues were discussed at most of the forums, the work was mainly taken forward by the Four Markets Group (Japan, Australia, Hong Kong and Singapore). The Group commissioned a paper to look at various aspects of bond market development, including trading arrangements, settlement and clearing and the role of credit rating agencies. Aspects of the paper are to be discussed further with private sector market participants at a meeting arranged for later this year by the Japanese Ministry of Finance.

INTERNATIONAL CO-OPERATION

In addition to participating in international discussions and programs, the RBA also regularly provides bilateral technical assistance to countries, mainly in the Asia-Pacific region. On occasion, it also provides financial support,



The Governor addressing a gathering of investors in London.

usually by means of a foreign exchange swap between the RBA and the central bank of the country concerned. Any such financial arrangement is provided on commercial terms and therefore at no cost to the RBA. Such activities are distinct from the Commonwealth Government's aid programs, but because they nonetheless have a significant foreign policy element, and are therefore broader than pure central banking, the RBA acts only with the support of, or at the request of, the Commonwealth Government.

FINANCIAL SUPPORT

During the year, the RBA, at the request of the Commonwealth Government, provided a temporary facility to the Bank of Papua New Guinea through a foreign exchange swap. The facility provided bridging finance to Papua New Guinea pending the establishment of an IMF/World Bank program and an accompanying longer-term loan from the Commonwealth

Government. The facility, which was for the Australian dollar equivalent of US\$80 million, was provided in December 1999 and repaid in June 2000 when the Commonwealth facility commenced.

The swap agreement entered into with the Bank of Thailand in 1997, as part of a US\$17 billion IMF-led financing package, remained in place during the past year. However, with economic conditions in Thailand improving, no draw-downs have been made since July 1999. The amount drawn remains at US\$862 million, against a limit of US\$1 000 million. Repayments under the swap are due to commence early in 2001.

TECHNICAL ASSISTANCE

For many central banks in the region, the past year saw an intensification of their efforts to upgrade their operations across a wide range of central bank functions. In many cases, this was in response to lessons learnt during the financial crisis a couple of years ago. A



number of these sought assistance from the RBA in this work or asked to visit the Bank to study the approach it adopts in carrying out its various functions. During the year, the RBA received 18 study visits from regional central banks; the main areas of interest were financial market operations, note issue, accounting and auditing.

The RBA also responded positively to a number of requests from overseas central banks for staff to provide technical assistance. One staff member was allocated to work full-time in providing technical assistance to the Bank of Papua New Guinea, and another was provided for a short-term project on debt management issues. Another member of staff has worked as adviser to the Central Bank of Samoa since 1998 (with the cost met by the IMF). Other staff visited the South African Reserve Bank, to assist with policy and technical aspects of an inflation-targeting regime, and the Bank of Thailand, to assist with

the development of an RTGS system. RBA staff have also participated on missions, led by the IMF or other agencies, to Thailand and India and participated in regional workshops in Indonesia, Malaysia, and Singapore.

The Deputy Governor, Stephen Grenville, served on the Independent Review Committee of the Indonesian Bank Restructuring Agency (IBRA), which is charged with the task of handling the bad debt problems incurred by the Indonesian banking system.

CO-ORDINATION WITH OTHER GOVERNMENT AGENCIES

The RBA is one of several Commonwealth Government departments and agencies which are involved in international economic policy and relations. Others include the Department of Foreign Affairs and Trade, the Treasury and AusAID. Co-ordination among these and other relevant agencies is through the International Economic Policy Group, which is chaired by the Department of Prime Minister and Cabinet and meets about once a month.

PROMOTING AUSTRALIA AS A FINANCIAL CENTRE

While the RBA's main focus in its international work has been on the improvement of the international financial system itself, it has also sought at all times to promote Australia as an example of an economy with sound and efficient financial markets. This has included support for AXISS, the Government's initiative to promote Australia as a centre for global and regional finance, including through the secondment of a senior staff member of the RBA.