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First home buyers in Australia

Mark Rodrigues¹

This article seeks to contribute to our understanding of first home buyer behaviour, presenting a profile of first home buyers in Australia at various points in time over the past two decades. Understanding the social and economic characteristics of first home buyers, and how they have evolved over time, is an important input into the current debate on housing affordability.

While rising house prices have reduced affordability for first home buyers in recent years, first home buyer participation in the market remains consistent with demographic fundamentals, suggesting that — in aggregate — aspiring first home buyers are not being priced out of home ownership. This may be because other elements of affordability, such as first home buyer incomes and employment, have grown strongly in recent years, consistent with the strong domestic economy, and because of the lower cost and increased availability of credit.

¹ Domestic Economy Division, Australian Treasury. This article has benefited from helpful comments from Damien Dunn and Dan Smith. I would also like to thank Joseph Mercante for invaluable data assistance. Any remaining errors and omissions are my own. The views in this article are those of the author and are not necessarily those of the Australian Treasury.

Introduction

Home ownership is highly valued in Australian society. At an individual level, it is believed to provide benefits such as security, freedom and privacy, as well as a tangible investment vehicle through a regime of disciplined saving. At a broader level, it plays a central role in promoting social cohesion, participation and stability.² The importance of home ownership is reflected in Australia's rate of home ownership which, at around 70 per cent, is among the highest in the developed world.³

The substantial increase in established house prices in recent years has raised concerns that aspiring first home buyers are being priced out of home ownership, resulting in a reduced rate of home ownership.

To date, these concerns have been supported using evidence from summary measures of conditions in the first home buyer market, such as the proportion of applicants obtaining finance to purchase their first home relative to the rest of the market, and various housing affordability indicators. However, such measures by themselves can be misleading. Either by design or assumption, they typically approximate conditions experienced by home purchasers more broadly rather than by first home buyers specifically. In addition, summary measures by definition do not factor in all, and in many cases even most, of the determinants of home purchase decisions.

In order to assess the extent to which, if at all, first home buyers are having difficulty entering the housing market, the analysis must go beyond median measures of prices and income. Other factors such as the types and prices of homes specific to first home buyers, the relative ease of access to credit, the cost of credit, employment conditions and incomes, and life-cycle developments should also be considered.

This article looks at first home buyer-specific data to present an in-depth profile of first home buyers. Knowledge of the broader set of factors that weigh on first home purchase decisions should improve understanding of observed trends in first home buyer activity.

To do this, the article firstly analyses the extent to which first home buyer activity has fallen recently and the factors behind the decline. It is shown that the decline in first home buyer activity largely reflects an unwinding of the bring-forward associated with the *additional* First Home Owners Scheme (FHOS). Abstracting from this, the number of first home buyers currently purchasing homes appears broadly consistent with demographic trends.

² See, for example, Troy (1991).

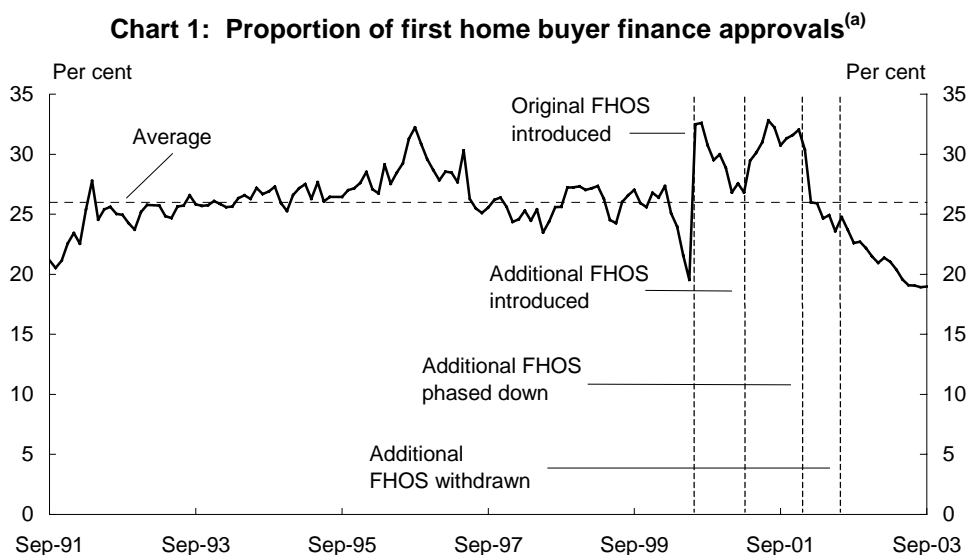
³ Australian Bureau of Statistics (2003).

The remaining sections of the article focus on the demographic, social and economic characteristics of recent entrants into the housing market, with a view to better understanding the factors underpinning the first home purchase decision. Some of the factors considered include the age and life-cycle cohort of first home buyers, the types of homes they purchase, and affordability indicators such as income, the cost and availability of finance, and employment status. The article concludes with a discussion of the findings, relating them back to observed first home buyer behaviour.

It should be noted that the data used to provide a demographic and social profile of first home buyers are most recently available for the three years to 2000-01. However, such characteristics evolve slowly over time, and therefore should remain relevant for more recent years. Economic variables are discussed with contemporary data sets (eg. finance and house prices). In addition, the results presented in this article are for all first home buyers, on average across all cities and regional areas, and hence may not necessarily be representative of conditions at the regional or individual level.

Recent trends in first home buyer activity

Part of the current debate on housing affordability has focused on the recent decline in the proportion of first home buyers in the owner-occupier housing finance market (excluding refinancing), from a peak of around 33 per cent two years ago to 19 per cent currently (see Chart 1). However, this measure is directly influenced by the significant strength in total market activity and the bring-forward and unwind of first home buyer activity associated with the FHOS.

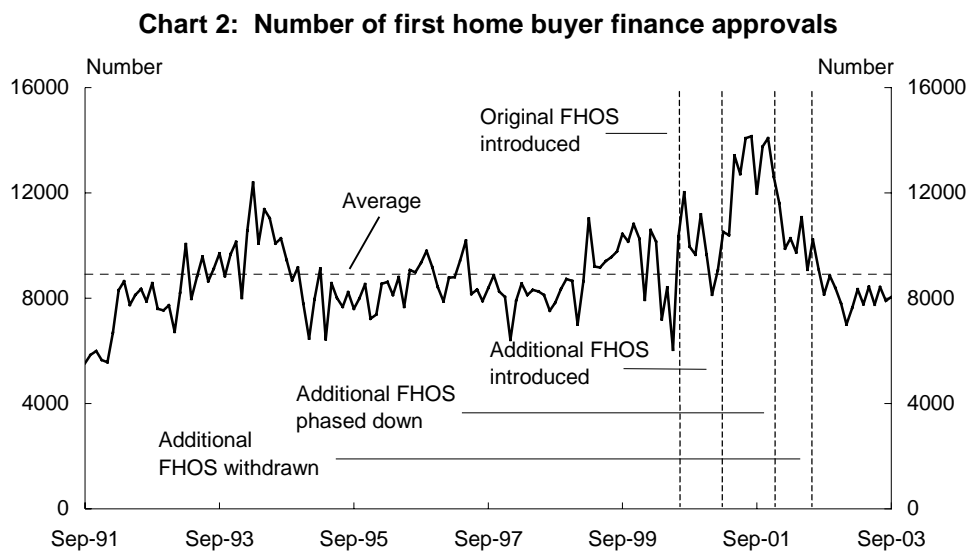


(a) Proportion of owner-occupied housing finance market (excluding refinancing).
Source: Australian Bureau of Statistics, *Housing Finance for Owner Occupation*, Cat. No. 5609.0.

First home buyers in Australia

Activity in the owner-occupier housing finance market (excluding refinancing) has risen from around 430,000 sales in 2000-01 to around 460,000 sales in 2002-03. As a consequence of the significant increase in sales activity, measures of first home buyer activity as a proportion of the total market are therefore likely to overstate the decline in the first home buyer segment of the market, given that first home buyer activity is motivated by different factors to that of the total market. The total market includes a significant number of sales related to either investment properties or those households upgrading (or downgrading) their current homes (see accompanying article, *Recent developments in the Australian housing market*).

Given the problems associated with analysing first home buyer activity relative to the rest of the market, it is likely to be more useful to focus on the actual number of first home buyers (see Chart 2).



Source: Australian Bureau of Statistics, *Housing Finance for Owner Occupation*, Cat. No. 5609.0.

First home buyer activity has been relatively volatile in recent years as first time home buyers responded to the incentives implicit in both the *original* and *additional* FHOS (see Box 1 for an explanation of the rationale behind the FHOS).⁴ The number of first home buyers obtaining finance fell to a low of around 6,000 per month prior to the introduction of the *original* FHOS on 1 July 2000, as aspiring first home buyers delayed their purchase to obtain the grant. Subsequently, first home buyer activity rebounded to a peak of over 12,000 per month following the introduction of the grant, reflecting the release of pent-up first home buyer demand. The *additional* FHOS, which was

4 According to Kupke and Marano (2002), for recipients of the FHOS, the grant was the most important element in the timing of purchase.

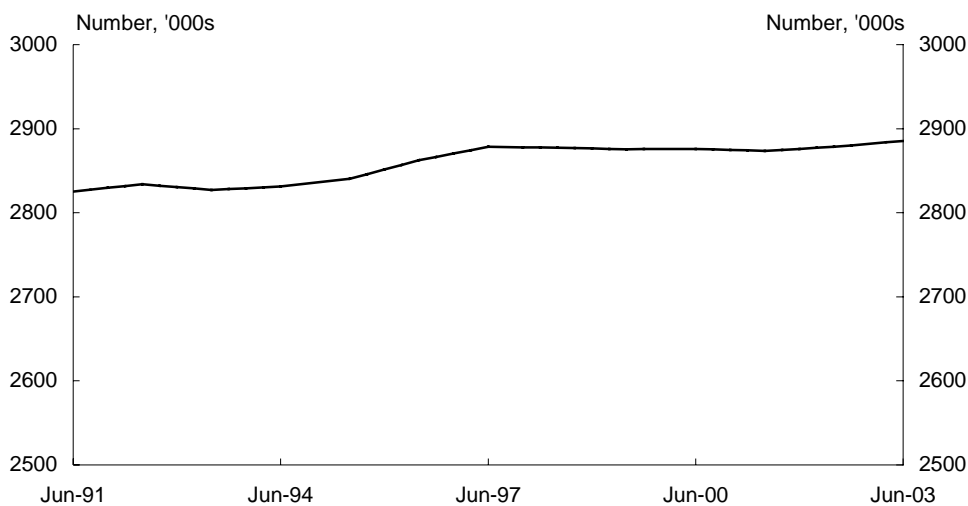
announced in March 2001, further stimulated demand, with the number of first home buyers averaging around 13,000 per month over the remainder of 2001. Thereafter, as expected, first home buyer participation in the market has fallen steadily, as the *additional* grant was phased down in January 2002, and eventually withdrawn in July 2002.

It is estimated that the unwinding of the bring-forward associated with the *additional* FHOS is now largely complete.

Looking through the recent volatility associated with the FHOS, the number of first home buyers is currently only slightly below its average since the early 1990s of just under 9,000 per month. Taking into account the unwinding of the earlier bring-forward, this may suggest that first home buyers are still gaining entry into the housing market at similar rates as in the past.

Since the population in the primary first home buyer age cohort (25 to 34 years) — one of the fundamental drivers of first home buyer demand — remained relatively stable over this period, a comparison with the long-run average is reasonable (see Chart 3). Other factors that have a major influence on first home purchases are discussed in the next section and, as the analysis demonstrates, these factors have been relatively stable as well.

Chart 3: Population aged 25-34 years



Source: Australian Bureau of Statistics, *Population by Age and Sex*, Cat. No. 3201.0.

Box 1: The rationale behind the First Home Owners Scheme

The FHOS was originally introduced on 1 July 2000 in order to compensate for price increases associated with the introduction of the Goods and Services Tax (GST). The scheme provides for a \$7,000 payment to be made to first time home buyers who enter into a contract to purchase a home — new or established — on or after 1 July 2000. While the GST is only levied on new homes, and the majority of first home buyers — some 80 per cent on average — purchase established homes, it was recognised that the increased cost of new homes would eventually flow through to the established market, as demand adjusted to the change in relative prices.

While the *original* FHOS represents compensation for the GST, and as such should have had a neutral effect on housing affordability, the willingness of first home buyers to defer purchases until its introduction suggests it was perceived as having some additional benefit over and above compensation for the GST.

In contrast, the *additional* FHOS that was introduced in March 2001, was designed to provide a short-term stimulus to activity in the residential construction sector. As such, the *additional* grant was introduced for a limited period, and applied only to first home buyers purchasing or building a new home.

The *additional* grant had an immediate impact on the first home buyer market, and the residential construction sector more generally. First, it brought forward the purchase decision to within the time frame specified within the grant. Second, it encouraged first home buyers who would otherwise have purchased an established dwelling to purchase a new dwelling. And third, it enabled a small number of people, who may never have become home owners, to purchase a home. It is important to note that while much of the increase in first home buyer activity in the second half of 2001 was a bring-forward of activity associated with the grant, which has subsequently been unwound, some of the increase in first home buyer activity was also due to low interest rates.

With respect to its impact on housing affordability, the *original* FHOS — considered as compensation for the GST — should have had a neutral impact on affordability. The *additional* FHOS is likely to have improved affordability for the first home buyers who received it, since any increase in first home prices associated with the *additional* grant would have been limited by the targeted nature of the grant (new homes).

Who are first home buyers?

Data in this section come from the Australian Bureau of Statistics' *Survey of Income and Housing Costs* for the years 1981-82, 1995-96 and 2000-01.⁵ Although the *Survey of Income and Housing Costs* is available for other years, these years were chosen to provide an adequate time span over which to analyse slowly evolving trends. For the purposes of this section, first home buyers refer to income units where the reference person has purchased a home within three years of the relevant survey, and had not previously owned or been purchasing a home.⁶

In the three years to 2000-01, around 420,000 Australians purchased their first home (see Table 1). Of these, around 86 per cent had a mortgage while the remaining 14 per cent did not have a mortgage. The surprisingly high proportion of first home buyers without a mortgage — which has remained relatively stable over the past two decades — possibly reflects the existence of high wealth individuals.⁷ It may also reflect the influence of recent immigrants purchasing their first home in Australia using the proceeds from the sale of their home overseas. Nevertheless, given the nature of the issues being examined, the remainder of this article will focus on first home buyers with a mortgage.

Table 1: First home buyers, number and tenure type

| | 2000-01 | 1995-96 | 1981-82 |
|-------------------|-------------------------------------|---------|---------|
| | Number ('000s) | | |
| First home buyers | 422.2 | 343.2 | 331.9 |
| With mortgage | 364.8 | 283.6 | 278.4 |
| No mortgage | 57.4 | 59.7 | 53.4 |
| | Per cent of total first home buyers | | |
| First home buyers | 100.0 | 100.0 | 100.0 |
| With mortgage | 86.4 | 82.6 | 83.9 |
| No mortgage | 13.6 | 17.4 | 16.1 |

Source: Australian Bureau of Statistics, *Survey of Income and Housing Costs*, Cat. No. 6541.0.30.001.

⁵ Note that data for 2000-01 are preliminary.

⁶ An income unit is defined as a person or group of related persons within a household, whose command over income is assumed to be shared. Income sharing is assumed to take place within married (registered or de facto) couples, and between parents and dependent children.

⁷ Interestingly, a large proportion of first home buyers without a mortgage have very low reported incomes. Studies have found that households reporting very low incomes also often report expenditure levels that are higher than households with higher incomes, suggesting the need to exercise some caution with data at the lower end of the income distribution. This may reflect access to savings from past income or other sources of wealth, or because reported income includes low or negative business income (Australian Bureau of Statistics, 2003).

Age and life-cycle characteristics of first home buyers

In broad terms, over the past two decades, first home buyers in Australia are most likely to have been relatively young, with over 60 per cent aged between 25 and 34 years (see Table 2). Further, the likelihood of being a first home buyer diminishes significantly with age, reflecting the fact that older people are more likely to already be existing home owners.

Table 2: Age of first home buyers with a mortgage

| | 2000-01 | 1995-96 | 1981-82 |
|-------------------------|---|---------|---------|
| | Per cent of first home buyers with a mortgage | | |
| Age of reference person | | | |
| 15-24 years | 9.8 | 14.6 | 13.9 |
| 25-34 years | 63.4 | 60.0 | 60.9 |
| 35-44 years | 20.5 | 20.8 | 15.5 |
| 45-54 years | 5.4 | 3.3 | 7.7 |
| 55-64 years | 0.9 | 1.0 | 1.6 |
| 65 years or over | 0.0 | 0.3 | 0.4 |
| Total income units | 100.0 | 100.0 | 100.0 |
| | Number ('000s) | | |
| Total income units | 364.8 | 283.6 | 278.4 |
| | Years | | |
| Median age | 32 | 32 | 27 |

Source: Australian Bureau of Statistics, *Survey of Income and Housing Costs*, Cat. No. 6541.0.30.001.

That said, the average age of first home buyers has increased. Between 1981-82 and 1995-96, the median age of first home buyers increased from 27 years to 32 years. However, this has stabilised at 32 years over the past 5 years.

Some have linked the ageing of the first home buyer cohort to declining affordability (see for example Yates, 2002). However, the stabilisation of the median first home buyer age between 1995-96 and 2000-01 coincides with a strong rise in house prices (up 36 per cent). So it is not clear that the earlier ageing of the first home buyer cohort was related to declining affordability. Also, there is substantial evidence to suggest that the increased delay in home purchasing between 1981-82 and 1995-96 may be related to broader social changes. Such changes include the deferral in family formation, which has traditionally preceded home purchase, longer periods spent in higher education or training, the changing composition of households, and the attractiveness of alternative forms of investment (Baum and Wulff, 2003).

Some of these social changes are evident in developments in the life-cycle characteristics of first home buyers over the past twenty years. For example, consistent with the tradition of partnering and family formation before home purchase, couples (with or without children) remain the most common group of first home buyers. However, they have been a declining proportion of first home buyers over the past twenty years. This decline is almost fully accounted for by the fall in the proportion of

first home buyers who are couples without dependent children where the reference person is aged 35 years or older (see Table 3).

This has been offset by an increase in the proportion of first home buyers who are lone persons, from around 20 per cent of first home buyers in 1981-82 to over 30 per cent in 2000-01. Most of these were under the age of 35.

Couples with children represented over a third of households that bought their first home in the three years to 2000-01. This is broadly unchanged from the early 1980s.

Table 3: Selected life-cycle characteristics of first home buyers with a mortgage

| | 2000-01 | 1995-96 | 1981-82 |
|---|---|---------|---------|
| | Per cent of first home buyers with a mortgage | | |
| Lone person | 30.4 | 32.1 | 20.7 |
| Lone person under 35 years | 25.2 | 25.6 | 15.8 |
| Couple | 66.8 | 63.9 | 77.1 |
| Couple only | 36.7 | 31.7 | 45.8 |
| Couple only, ref. person under 35 years | 32.0 | 27.0 | 32.1 |
| Couple with children | 30.1 | 32.2 | 31.2 |

Source: Australian Bureau of Statistics, *Survey of Income and Housing Costs*, Cat. No. 6541.0.30.001.

Types of homes purchased by first home buyers

The types of homes sought by first home buyers are also an important element of the home purchase equation. In general, the type of housing chosen by first time home buyers is consistent with the stage of life-cycle developments outlined above, their incomes (which is discussed in the following section), and the type of housing stock available in Australia.

Detached houses remain the most common type of home purchased, representing over 80 per cent of all homes purchased by first home buyers in 2000-01 (see Table 4). This is consistent with the predominance of families — couples with or without dependent children — in the first home buyer cohort, and the relative proportion of detached houses in the housing stock. That said, higher density dwellings represent an increasing proportion of homes purchased by first home buyers, increasing from around 10 per cent two decades ago, to around 20 per cent in 2000-01. Again, this is consistent with the increasing proportion of first home buyers who are lone persons, and the increasing proportion of higher density dwellings in the overall housing stock.

First home buyers in Australia

Table 4: Type of dwelling purchased

| | 2000-01 | 1995-96 | 1981-82 |
|--------------------|---|---------|---------|
| | Per cent of first home buyers with a mortgage | | |
| Dwelling structure | | | |
| House | 80.5 | 82.6 | 89.6 |
| Medium density | 19.0 | 17.1 | 10.1 |
| Other | 0.5 | 0.3 | 0.3 |
| Total income units | 100.0 | 100.0 | 100.0 |
| | Number | | |
| Total income units | 364.8 | 283.6 | 278.4 |

Source: Australian Bureau of Statistics, *Survey of Income and Housing Costs*, Cat. No. 6541.0.30.001.

The vast majority of first home buyers purchase established homes (see Table 5). In 2000-01, over 80 per cent of first time home buyers purchased an established home, up slightly from 1995-96. Consistent with this, more recent FHOS data suggest that the proportion of first home buyers purchasing established homes has remained at a little over 80 per cent in the period since mid-2001.

The majority of first home buyers — over three quarters — purchase large houses with three or more bedrooms. This may be related to the needs of first home buyers, most of whom have a family. Further, there is evidence to suggest that the size of the homes purchased by first home buyers, as measured by the number of bedrooms, has increased over the past two decades. This in part reflects the increase in the size of new dwellings being built for the total market (Australian Bureau of Statistics, 1999).

Importantly, however, the increasing size of homes being purchased by first home buyers suggests that part of the higher prices being paid has been for an improvement in quality.

Table 5: Age and size of first home

| | 2000-01 | 1995-96 | 1981-82 |
|--------------------|---|---------|---------|
| | Per cent of first home buyers with a mortgage | | |
| Age of home | | | |
| New | 19.1 | 23.3 | n.a. |
| Established | 80.9 | 76.7 | n.a. |
| Number of bedrooms | | | |
| None or one | 1.8 | 4.0 | 1.6 |
| Two | 21.1 | 22.5 | 19.4 |
| Three | 56.9 | 62.1 | 66.9 |
| Four or more | 20.2 | 11.5 | 12.1 |

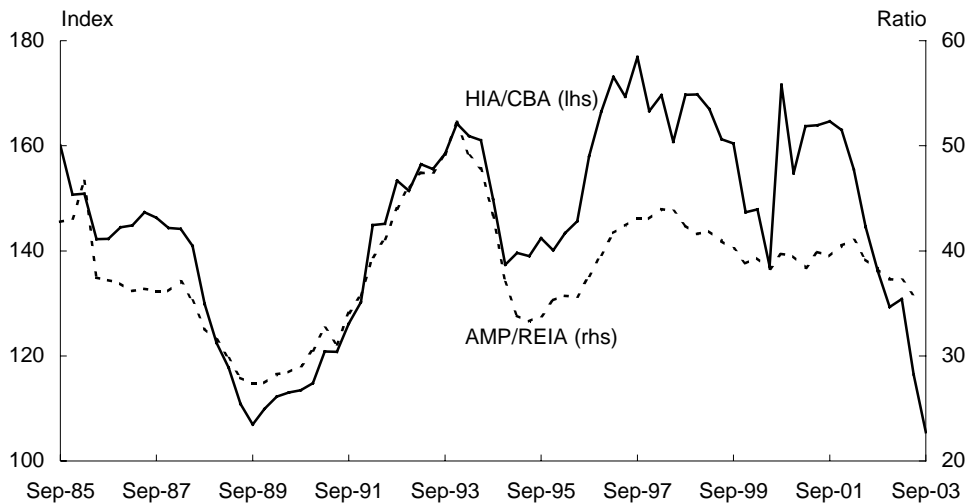
Source: Australian Bureau of Statistics, *Survey of Income and Housing Costs*, Cat. No. 6541.0.30.001.

Affordability for recent first home buyers

Much of the discussion over housing affordability in Australia has been stimulated by significant declines in some summary indicators of affordability in recent years. Such affordability indicators are often used as a proxy for the relative ease of access to, and servicing of, loans for prospective first home buyers.

The strong rise in established house prices has been the major driver of the decline in these summary measures of housing affordability in recent years. For example, the index produced by the Housing Industry Association and the Commonwealth Bank of Australia fell from a near record high of around 170 index points in September 2000 to around 105 index points in September 2003, as a result of house prices (as reported by the Commonwealth Bank) rising by almost 100 per cent over that period. However, the indicator produced by the Real Estate Institute of Australia and AMP, which uses house prices collated from the various state branches of the Real Estate Institute, has not fallen nearly as much over that period, with the Real Estate Institute of Australia reporting a rise in house prices of around 50 per cent between the September quarter 2000 and the June quarter 2003 (see Chart 4).⁸

Chart 4: Selected summary measures of housing affordability



Source: Commonwealth Bank of Australia, Housing Industry Association, AMP and Real Estate Institute of Australia.

⁸ The Commonwealth Bank/Housing Industry Association Housing Affordability Index is calculated as the ratio of average household disposable income to the minimum income required to be able to service a loan based on the current median house price and prevailing interest rate (qualifying income). The AMP/Real Estate Institute of Australia Home Loan Affordability Indicator is calculated as the ratio of family income to average loan payments.

First home buyers in Australia

While the strong increase in house prices in recent years is well established, estimates as to the magnitude of this increase and the resulting size of the loan required to purchase a first home vary widely, with major implications for the overall indicator itself. For example, the Housing Industry Association/Commonwealth Bank of Australia indicator assumes an 80 per cent loan to valuation ratio on the market-wide median house price (which was approximately \$320,000 in the September quarter 2003). The average first home loan size reported by the Australian Bureau of Statistics was closer to \$186,000 in the September quarter 2003, significantly less than the median loan size on which the Housing Industry Association/Commonwealth Bank of Australia indicator is based.⁹ As such, prices paid (and loan sizes) by first home buyers appear less than what median house price estimates suggest. This is consistent with anecdotal evidence that suggests that first home buyers purchase less expensive homes, and in areas that have gone up less in price than the broader market.

Also, further caution should be exercised when interpreting such summary measures of affordability. While the significant rise in house prices has undoubtedly had a negative impact on the affordability of housing for first home buyers, summary measures tend to overstate the magnitude of changes in affordability because they do not fully depict the overall affordability picture for first home buyers.

By definition, the above measures are only an approximation of the conditions faced by aspiring first home buyers, and often use information related to overall market conditions rather than the conditions directly relevant to first home buyers. In addition, they may not include all the variables relevant in ascertaining home ownership. These other factors include strong employment outcomes and improved access to finance, which have exerted a positive influence on affordability in recent years.

While the loan required by first home buyers has increased significantly, there is evidence to suggest that first home buyers are not having trouble servicing higher debt levels. Liaison with major banks and mortgage originators indicates that the majority of first home buyers are ahead in their repayments and are repaying their loans more frequently than the standard monthly repayment. Also, default rates and mortgage insurance claims for first home buyers have fallen to very low levels, consistent with trends in the broader market.

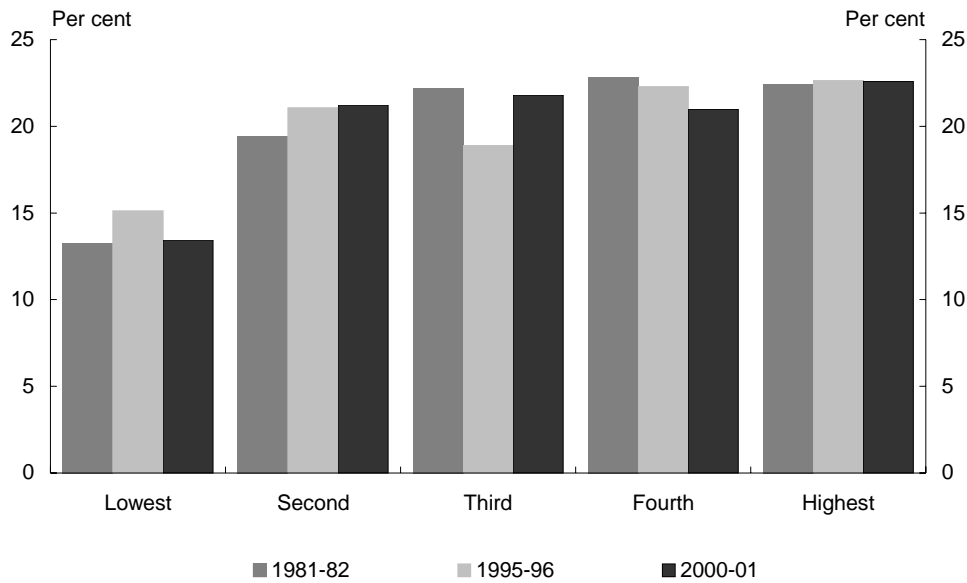
The strong financial position of first home buyers is consistent with evidence that first home buyers generally have high incomes and are in full-time employment. Around two-thirds of first homebuyer households are ranked in the third, fourth and fifth income quintiles (see Chart 5). The relatively high average incomes of first home

⁹ Australian Bureau of Statistics, Housing Finance for Owner Occupation, Cat. No. 5609.0.

buyers possibly reflects the concentration of first home buyer households in the 25 to 44 years age cohort, who, on average, have higher incomes than say retirees.

Importantly, over the past twenty years, the income distribution of first home buyers has remained broadly unchanged, providing some evidence that people at the lower end of the income distribution are no less likely to become first home owners than they were twenty years ago.

Chart 5: Income distribution of first home buyers



Source: Australian Bureau of Statistics, *Survey of Income and Housing Costs*, Cat. No. 6541.0.30.001.

Strong labour market outcomes have also helped first home buyers enter the market. In 2000-01, 90 per cent of first home buyers were in full-time employment while a further 3.6 per cent were in part-time employment (see Table 6). More recently, the unemployment rate for 25 to 34 year olds has fallen to 5.2 per cent, its lowest level since December 1989. In addition to strong employment outcomes, the relatively high proportion of first home buyers in full-time employment may also be an important element supporting affordability (Kupke and Marano, 2002).

Table 6: Employment status of first home buyers with a mortgage

| | 2000-01 | 1995-96 | 1981-82 |
|---|---------|---------|---------|
| Per cent of first home buyers with a mortgage | | | |
| Full-time | 90.0 | 87.4 | 91.9 |
| Part-time | 3.6 | 6.1 | 3.8 |
| Unemployed | 3.5 | 2.5 | 2.1 |
| Not in the labour force | 2.9 | 4.1 | 2.2 |

Source: Australian Bureau of Statistics, *Survey of Income and Housing Costs*, Cat. No. 6541.0.30.001.

First home buyers in Australia

The structural decline in interest rates over the past decade has also played a significant role in improving aspiring first home buyers' access to the housing market. Since the 1990s, standard housing interest rates have fallen from a peak of 17 per cent to near 30-year lows of around 6.8 per cent currently. This reflects the fall in inflation over the period and the benefits of increased competition stemming from financial market deregulation.

Financial market deregulation has not only aided in a reduction in interest rates, but has increased the supply and diversity of lending products, making it easier for first home buyers to access the housing market.

Concluding remarks

While the strong rise in house prices in recent years has undoubtedly reduced affordability for first home buyers, the magnitude of the decline appears to have been overstated by some summary measures of affordability. This may reflect the limited nature of affordability measures or the fact that they are not well tailored to first home buyers.

First home buyer activity appears broadly consistent with demographic fundamentals, and recent declines in the level of first home buyers largely reflect an unwind of first home buyers brought forward by the FHOS.

Using recent first home buyers as a proxy for aspiring first home buyers, the article finds that access to the housing market has, to date, not been significantly reduced by the strong rise in house prices. Most first home buyers are middle to high income earners and have the stability of being in full-time employment. As a consequence, recent first home buyers are not having trouble paying down their loans, with many actually ahead of repayments.

Interestingly, while the average age of first home buyers appears to have increased over the past twenty years, since the mid-1990s this appears to have stabilised. More importantly, the ageing of the first home buyer cohort could be related to broader social developments rather than a decline in affordability. Such developments include the deferral of marriage and family formation, which typically precedes home purchase. In addition, higher prices being paid by first home buyers partly reflect the increasing size of their homes, consistent with the family motive of home purchase and the increasing size of homes more generally over the past two decades.

It should be remembered, however, that the various measures of affordability cited in this article are heavily influenced by conditions in the general economy and by the overall confidence of households. The strong domestic economy over the past decade has continued to provide opportunities for many first home buyers. Nevertheless, a

significant slowing in economic activity especially with respect to employment, or a significant rise in interest rates, could have a detrimental affect on housing affordability. However, to the extent that such conditions could also impact on house prices — either slowing the rate of growth significantly or possibly reducing prices in some markets — this would lead to improved affordability.

First home buyers in Australia

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Recent developments in the Australian housing market

James Bond¹

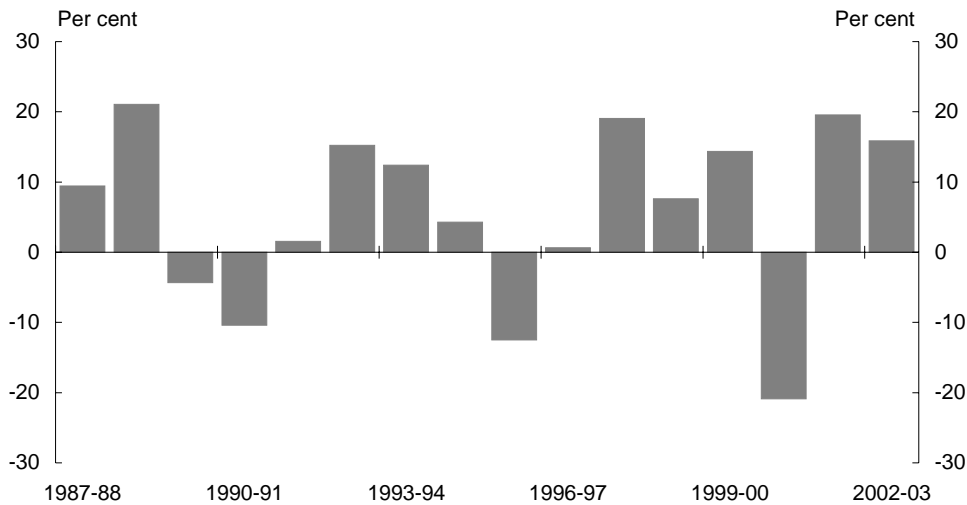
Housing plays an important role in Australia's economic growth and in the welfare of Australians. This article examines developments in the Australian housing market over recent years. It argues that investors have played an increasingly important role in the housing market for both detached houses and apartments.

1 Domestic Economy Division, Australian Treasury. I would like to thank Damien Dunn for detailed comments and Michael Harvey and Dan Smith for valuable assistance. The views in this article are those of the author and are not necessarily those of the Australian Treasury.

Housing activity

The residential property cycle in recent years has played a significant role in Australia's overall economic performance. In the past two years, dwelling investment rose by 20 per cent, and 16 per cent respectively (see Chart 1) contributing around 1 percentage point to GDP growth in each of these years.

**Chart 1: Investment in dwellings^(a)
(volumes, year average growth)**



(a) Includes construction of new dwellings and alterations and additions.
Source: ABS Cat. No. 5206.0.

In terms of the number of dwellings constructed around, 170,000 dwellings (or 2.2 per cent) were added to Australia's total housing stock of 7.8 million in the past year. Of those dwellings built, around 66 per cent were detached houses and 34 per cent were medium density dwellings (semi-detached, terrace houses, town houses, flats, units and apartments).

The housing industry is a major employer and has made a significant contribution to Australia's employment growth over the past five years. Around 390,000 people are directly employed in residential construction, an 8 per cent increase on two years ago.² A further 130,000 people were also employed indirectly as real estate agents, architects and other property professionals.

² Australia's total employment grew by around 3.8 per cent over the same period. Excluding construction it grew by 3.0 per cent. Source: ABS Cat. No. 6291.0.55 electronic publication and unpublished industry data.

Overall, housing construction has in recent years contributed significantly to economic growth and incomes, with the current cycle now appearing relatively mature compared with past cycles.

Recent trends in house prices³

Over the past decade, established dwelling prices have increased by around 110 per cent in nominal terms. Much of this growth occurred in the second half of the decade, with prices growing by 76 per cent over the past five years (Chart 2).⁴ The median price of an established detached dwelling has risen from \$148,000 in June 1993 to \$358,000 in June 2003.⁵ Similar increases have been recorded in the prices of medium density dwellings, which have risen from \$115,000 to \$278,000.

Despite considerable variation in house prices across states and territories (see Box 1 *State Comparisons*), there has been strong growth in prices generally across most of Australia. The significant rise in prices across states and territories reflects broad economic and demographic drivers of demand, with some of the variation in prices partly reflecting geography and location.

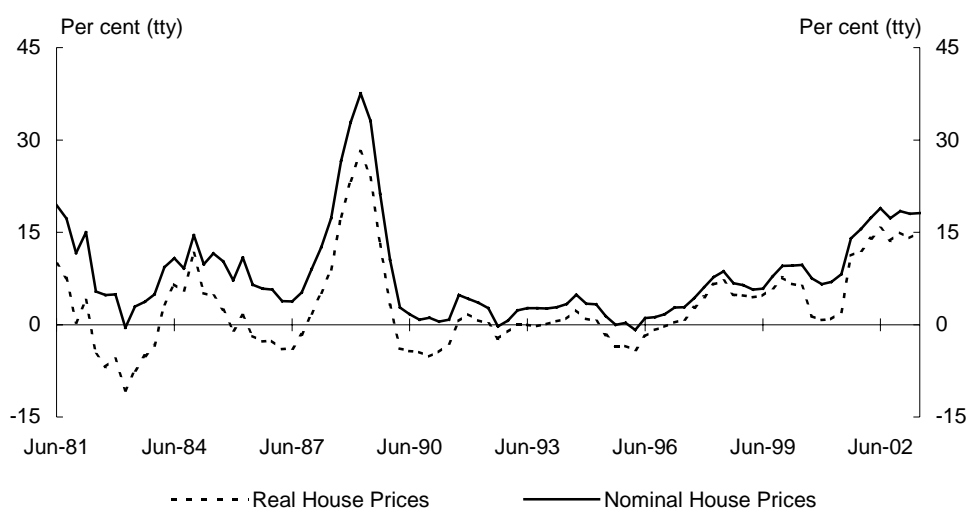
3 Per cent changes in dwelling prices are calculated from ABS House Prices Indexes (ABS Cat. No. 6416.0). Data on median house prices are taken from the Real Estate Institute of Australia (REIA) publication; Market Facts.

4 A number of problems exist when measuring price changes for established dwellings. First, the physical characteristics of dwellings such as the number and size of rooms, the quality of materials and fittings and the age of dwellings are likely to differ. Similarly, the quality and size of homes tends to increase over time. Second, the geographical location of dwellings has a significant influence on prices. This may reflect a combination of local amenities such as views, transport or proximity of work places and access to services such as schools. Lastly, some quarterly estimates of dwelling prices only reflect the value of dwellings sold in each quarter. The result is that the average price of dwellings sold in each quarter is affected by these compositional issues and a rise or fall in prices may relate to changing composition of houses and not to actual house price inflation.

5 REIA Market Facts.

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Chart 2: Established house prices



Source: ABS Cat. No. 6416.0 and REIA Housing Market Facts.

As seen in the above chart, large increases in house prices are not unprecedented in history and, in part, reflect the cyclical nature of the housing market. Australia's established house prices increased by 56 per cent over the two years between June 1987 and June 1989. However, there were some notable differences between the rise in house prices then and the increases witnessed in recent years (*Box 2 The Tale of Two Housing Cycles*).

Despite the general perception that house prices can only go up, Australia has actually experienced falls in house prices, especially in real terms. Between March 1989 and December 1990, real house prices fell by 8 per cent and did not recover to the same levels until a decade later. Some individual markets in Australian cities recorded greater falls in the early 1990s. Dwelling prices in Melbourne fell by 22 per cent in real terms between March 1989 and March 1996. This is similar to international experience. In the late 1980s and early 1990s, the United Kingdom, Finland, Norway, and Sweden experienced peak to trough falls in prices of greater than 25 per cent.⁶ Sharper falls have been observed in some South and East Asian economies over the 1990s, particularly in Hong Kong and Japan.

⁶ According to the Bank of International Settlements, peak to trough falls in real prices recorded in the late 1980s and early 1990's include: Finland 50 per cent, Norway, 48 per cent, Sweden 30 per cent, and United Kingdom 30 per cent.

Box 1: State comparisons

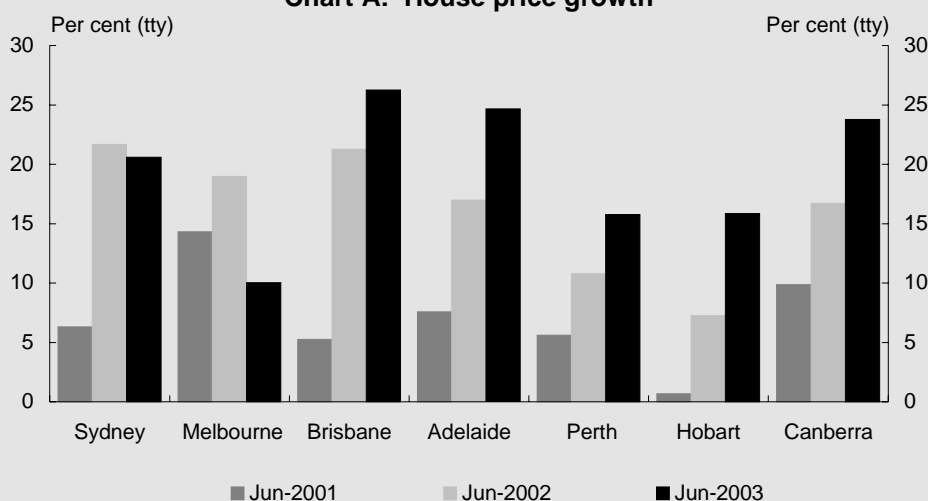
There is considerable variation in house prices and investor participation in the market across states and territories. Median house prices range from \$180,000 in Hobart to \$465,000 in Sydney, whilst the median price of a medium density dwelling ranges from \$127,500 in Hobart to \$364,600 in Sydney Table A (at June 2003).

Table A: Prices of houses and medium density dwellings by state (nominal)

| | Sydney | Melbourne | Brisbane | Adelaide | Perth | Hobart | Canberra |
|------------------------|-----------|-----------|----------|----------|-------|--------|----------|
| | (\$' 000) | | | | | | |
| Detached Houses | | | | | | | |
| Jun-1993 | 180.0 | 145.0 | 125.0 | 111.9 | 108.7 | 105.0 | 159.5 |
| Jun-2003 | 465.0 | 359.0 | 289.0 | 220.0 | 210.2 | 180.0 | 305.0 |
| Medium Density | | | | | | | |
| Jun-1993 | 139.0 | 111.3 | 102.5 | 92.7 | 79.0 | 81.8 | 127.5 |
| Jun-2003 | 364.6 | 279.0 | 207.0 | 165.0 | 159.0 | 127.5 | 255.0 |

Source: REIA: Market Facts.

While house price growth in Melbourne and Sydney slowed in 2003, prices in other state capitals increased (Chart A). Price growth in Brisbane increased from 21 per cent through the year to June 2002 to 26 per cent through the year to June 2003. Notably, Melbourne is the only city to show a noticeable slowing in year on year price growth. Growth in prices in Melbourne slowed from 19 per cent in June 2002, to 10 per cent in June 2003 (Source: ABS Cat. No. 6416.0).

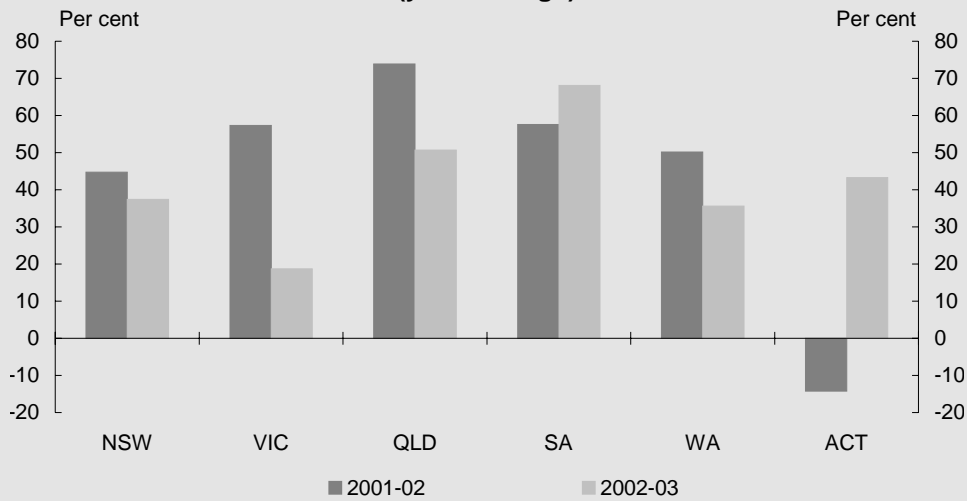
Chart A: House price growth

Source: ABS Cat. No. 6416.0.

Box 1: State comparisons (continued)

The states and territories recording the strongest growth in prices the past two years also recorded the strongest growth in investor finance: Queensland, South Australia and the ACT (Chart B).

Chart B: Growth in investor finance by state (year average)



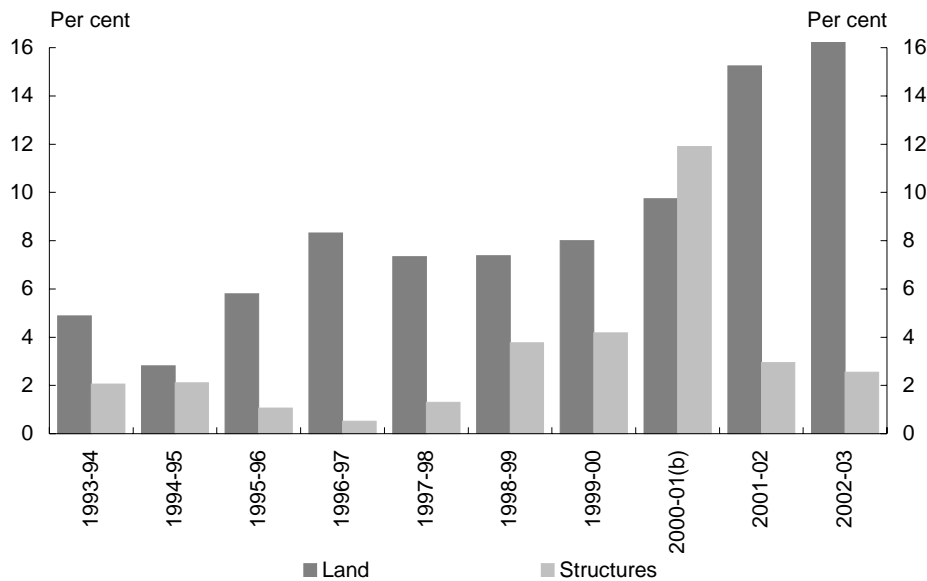
Source: ABS unpublished data.

Land prices

One of the major factors contributing to the increase in established house prices in recent years has been the notable increase in the price of the land component. The real price of land has risen by around 12 per cent per annum since 1992 (Chart 3), while the price of constructing a dwelling has increased by around 3 per cent per annum (2.0 per cent excluding the impact of *The New Tax System*), around the annual rate of inflation.⁷

⁷ This analysis is based on the Annual National Accounts (ABS Cat. No. 5204.0), which publishes estimates of the value of land and dwellings (excluding land) and the ABS House Price Indexes (ABS Cat. No. 6416.0), which publishes an index for both established dwellings (including land and building), and for a project homes (building excluding land).

Chart 3: Growth in land and house prices^(a)



(a) The spike in growth in prices of structures in 2001 reflects the one-off impact of the GST on housing related materials and services. However, the increase in the purchase price was offset by the introduction of the First Home Owners Grant (for further information see the accompanying article *First Home Buyers in Australia*.)

(b) 2000/01 includes the impact of the new tax system.

Source: ABS Cat. No. 5204.0.

According to the Annual National Accounts, the price of an established dwelling has increased 65 per cent over the past decade, with land contributing 52 percentage points to that increase and the cost of constructing a dwelling contributing only 13 percentage points.⁸ That is, the land component has contributed around 80 per cent to the increase in the price of an established dwelling.

This would therefore suggest the demand for land, and hence the available supply or release of land, may be an important factor behind the recent rise in house prices. Higher costs associated with greenfield developments and urban infill may have also played a role. Determining this would require detailed investigation of housing and land supply, which is not the focus of this paper.

8 Note that these quality adjusted price deflators items are not additive.

Box 2: The tale of two housing price cycles

Australia experienced a sharp run-up in housing prices in the late 1980s following a seven-year period of relatively flat growth. In line with inflation, house prices grew at around 8 per cent per annum in nominal terms in the seven years prior to 1987, before increasing sharply by 56 per cent over the following two years to June 1989.

The current boom differs to the experience of the 1980s. During the current cycle, steady growth in house prices has been recorded over the past seven years. As such, the 1980s cycle appears to have been a relatively short lived phenomenon compared with the prolonged growth in house prices since 1996 (see Chart A).

Although some of the circumstances and economic events behind these two cycles are similar, there are notable differences. In particular, inflation in the late 1980s was considerably higher than today and as such the real increase in house prices in the 1980s was significantly less than the nominal price increases.

Between June 1987 and June 1989, real house prices rose by 35 per cent, somewhat comparable to the 33 per cent rise in the two years to June 2003. However, the lead up to the 1980s episode saw real prices decline by 5.6 per cent between June 1985 and June 1987. This is significantly different from the strong sustained growth witnessed over the past seven years, which has contributed to one of the longest periods of continuous real house price growth on record.

A common theme to both periods was a surge in investor activity following a collapse of share market values. In October 1987 the share market fell by over 40 per cent. In the following two years, the investor share of total housing finance rose sharply from 13 per cent to a peak of 34 per cent in January 1989. Looking at the current cycle, between June 2001 and February 2003, the share market lost around 20 per cent in its value, one of the longest bear markets of recent times. Coinciding with the decline in share prices, investor activity as a share of total housing finance has also increased significantly, averaging around 45 per cent of total financing in the past year.

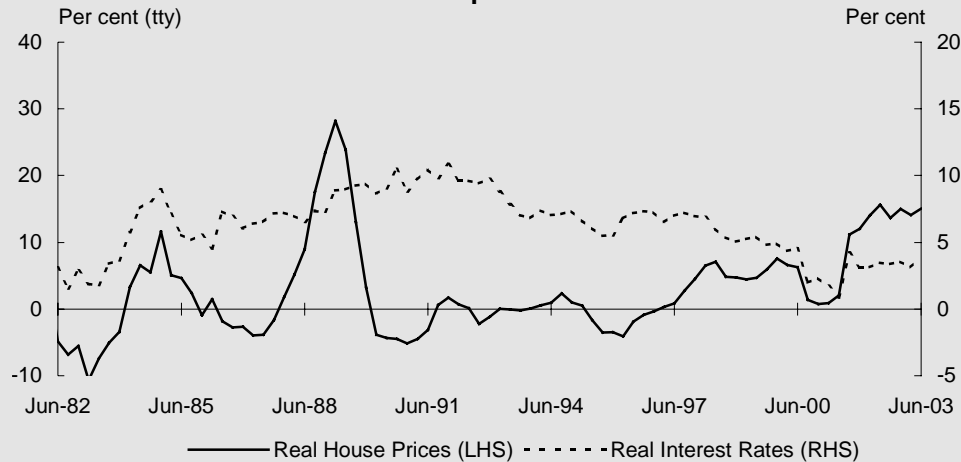
Some policy factors may have also played a role in the 1980s boom. The 1985 tax reform package included a measure that was aimed at limiting the negative gearing of rental property investments made after 17 July 1985. Under this measure, the deduction allowable each year for interest on borrowings was limited to the net rental income derived in that year. These restrictions were removed on 15 September 1987 just prior the stock market crash and the boom in housing investment.

Prior to the significant rise in house prices in the late 1980s, there was a cyclical decline in interest rates, with the standard variable rate falling from 15.5 per cent in July 1987 to 13.5 per cent by February 1988. The decline in interest rates was quickly

Box 2: The tale of two housing cycles (continued)

reversed, rising from 13.5 per cent in June 1988 to 17.0 per cent by June 1989, and as such may have played a significant role in the abrupt decline in the growth in house prices (Chart A) — where house prices fell by over 8 per cent in real terms between 1989 and 1991.

The structural decline in real interest rates over the past 5 years has been an important driver of house prices, as lower interest rates enabled households to service higher debt levels. As such, an increase in interest rates would reduce the ability of households to service high debt levels (assuming no change to incomes) and possibly lead to a decline in demand for housing and the growth in house prices, as was the case in the 1980s. The extent of decline, in real or nominal terms, is however dependent on a multitude of variables as highlighted in this article.

Chart A: Real house prices and interest rates

Source: ABS Cat. 6416.0 and RBA Bulletin Data Base.

Finally, another important economic variable affecting housing is the unemployment rate. In the lead up to the strong growth in house prices of the late 1980s, the unemployment rate was steadily declining. From its peak of 10.4 per cent in September 1983, the unemployment rate fell to 7.8 per cent by June 1987 and continued to fall to a trough of 5.6 per cent by December 1989. As a result, more households were in a better financial position to invest in housing in the late 1980s. However, coinciding with a sharp reversal in house prices, the unemployment rate then nearly doubled from 5.6 per cent in December 1989 to 10.9 per cent in December 1992.

Since 1994, the unemployment rate has fallen steadily from this peak of 10.9 per cent. In fact, the unemployment rate over the past two years has fallen by over 1 percentage point to below 6 per cent — its lowest level in over a decade. This decline in the unemployment rate coincides with the long expansion in house prices.

Housing demand

As highlighted so far, the supply of new housing has been rising strongly over the past two years, a period that has coincided with exceptional growth in house prices, indicating that housing demand continued to outpace supply. Housing demand can be attributed to many economic and demographic factors, although the importance of these factors depends on the reasons for purchasing a home. In essence, there are three reasons why people purchase homes; that is, they are either upgraders, first home buyers or investors.

Upgraders

Upgraders — classified as those households that already own or are paying off a house or apartment and are looking to upgrade the quality or location of their home account for around 44 per cent of total housing loans. Upgrading might be driven by factors such as household size (for example, having children), changes in employment, income, or economic circumstances (for example, wealth gains).

It is important to note that housing demand originating from upgrades will have a corresponding response in housing supply, as those upgrading to higher quality homes are by definition selling their current property (usually only with a short lag). Nevertheless, the activity of upgraders will have an important influence on housing demand and house prices. For simplicity, downgraders, those looking for cheaper or smaller accommodation (for example, retirees) are also included in this category.

First home buyers

First home buyers typically originate from either changes in household formation (children leaving home, divorce etc.), from immigration or from those leaving the rental market. Unlike upgraders, first home buyers create additional demand for dwellings without a corresponding property sale. First home buyers currently account for around 10 per cent of total loans for housing, although their share reached a peak of 20 per cent following the introduction of the First Home Owners Grant in July 2000. While the proportion of first home buyer activity relative to the rest of the market has fallen from record high levels in recent years, this reflects a significant increase in turnover and refinancing in the total housing market. The current actual level of first home buyers (8000 in September 2003) is only slightly below the long-run average level of around 8900 loans per month.

Investors

The final category contributing to housing demand is investors who are those households or corporations that own dwellings for the purposes other than owner occupation. Investors purchase properties for either an income stream (rents) and/or

expected capital gains, and as such their demand is notably influenced by interest rates or the performance of other asset classes. This is unlike first home buyers who are primarily driven by demographic or social factors (although some factors will undoubtedly overlap).

Investors have grown in importance in the housing market over the past 20 years. Investors' share of total housing finance increased from around 20 per cent in the 1980s to average 37 per cent over the past five years (Chart 4). Growth in investors' role in the market has been particularly strong over the past two years, increasing from 35 per cent in 2000-01 to 45 per cent in the three months to September 2003.

Given investors' large and growing share of the Australian housing market the second part of this article focuses on investors and the key drivers of investor activity. (First home buyer activity is discussed in the accompanying article *First Home Buyers in Australia*.)

Investors contribute strongly to housing demand

As stated earlier, investors currently account for a significant proportion of total housing finance. Investors are either households, or companies, trusts and corporations.

**Chart 4: Investor loan approvals
as a proportion of total housing finance^(a)**



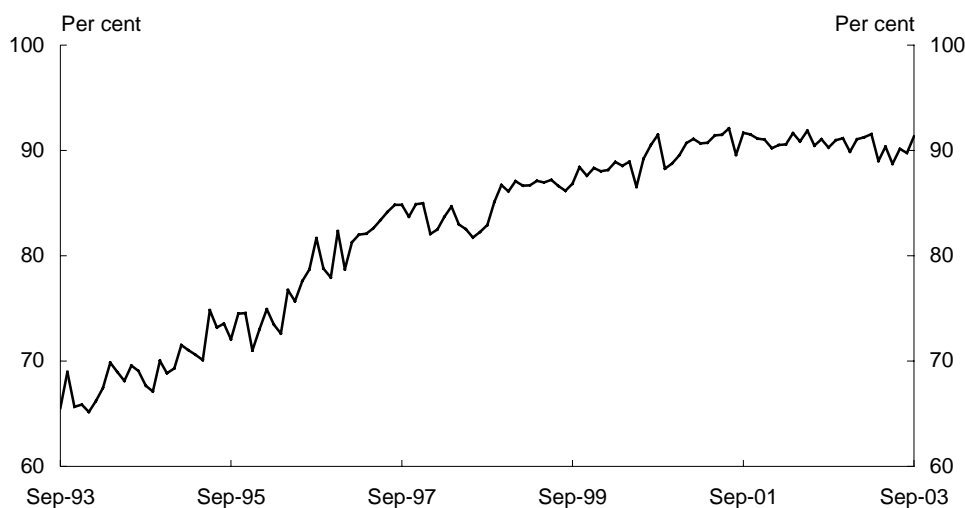
(a) Excludes refinancing of existing homes and alterations and additions.
Source: ABS Cat. No. 5671.0

An important development over the past decade has been the growing importance of households, rather than corporations, as investors. At the beginning of the 1990s,

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households accounted for around 65 per cent of lending for the purchase of established dwellings for investment. This has grown to around 90 per cent in 2002-03 (Chart 5).

**Chart 5: Individual investors
as a proportion of total investors^(a)**



(a) Excludes construction of dwellings for rent or resale.
Source: Treasury derived from ABS Cat. No. 5671.0.

However, that is not to say corporations are moving away from housing as an investment class. Over the past two years, the value of investment by corporations in residential property has nearly doubled.

Despite the popular perception that investors are typically only interested in medium density dwellings, investors own 50 per cent detached houses and 50 per cent medium density dwellings. However, of the total number of medium density dwellings constructed each year, investors on average are estimated to approximately account for 70 per cent.

Fundamental drivers of investor demand

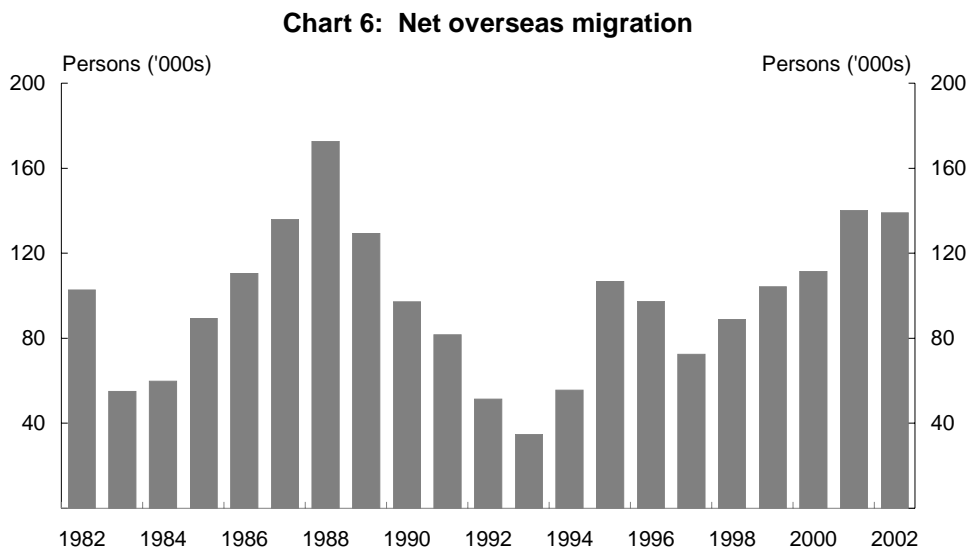
Investor demand for housing is largely driven by the current economic circumstances of individuals and a series of other economic factors relating to them, such as interest rates, incomes (rent and personal) and the performance of equity markets.

Before examining some of the economic factors which are important drivers of investor demand, it is worth first reflecting on the key driver of the housing market as a whole i.e. population growth. Population growth and household formation will directly or indirectly influence investors' decisions, be it through higher demand for rental properties or the future sale of the property.

Population

Population growth is the key driver of demand for housing. In Australia, the total estimated resident population has increased, on average, by 240,000 persons per annum over the past five years. The housing requirements of this ongoing increase in population must be met through the construction of new dwellings.

Australia's natural population increase, that is the number of births over deaths, has averaged 120,000 persons per annum over the past five years. This has been broadly matched by net migration, which has averaged around 117,000 people per annum over the past five years, with the intake increasing over this period (Chart 6).⁹ Migrant households typically rent in the first few years in Australia and new migrant households have a direct impact on demand for rental properties.



Source ABS Cat. No. 3101.01.

Long-run social and demographic changes are also increasing demand for dwellings. Between 1991 and 2001, Australia's population increased by 12 per cent while the number of private occupied dwellings increased by 21 per cent. The average size of a household decreased from around 2.8 persons to around 2.6 persons over this period. There are a number of factors contributing to smaller households including, declining marriage rates, an increasing number of divorces and fewer group houses. Between 1991 and 2001 there was a 43 per cent increase in the number of lone person

⁹ The ABS has advised that due to adjustments made to category jumping, immigration estimates may be overestimated. For further information please see Demography Working Paper 2003/1 — Estimated Resident Population and Measurement of Category Jumping.

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households and a 37 per cent increase in the number of lone-parent households leading to an increase in demand for houses.¹⁰ In general, the smaller the size of an average household, for a given level of population, the greater is the number of dwellings required to house them.

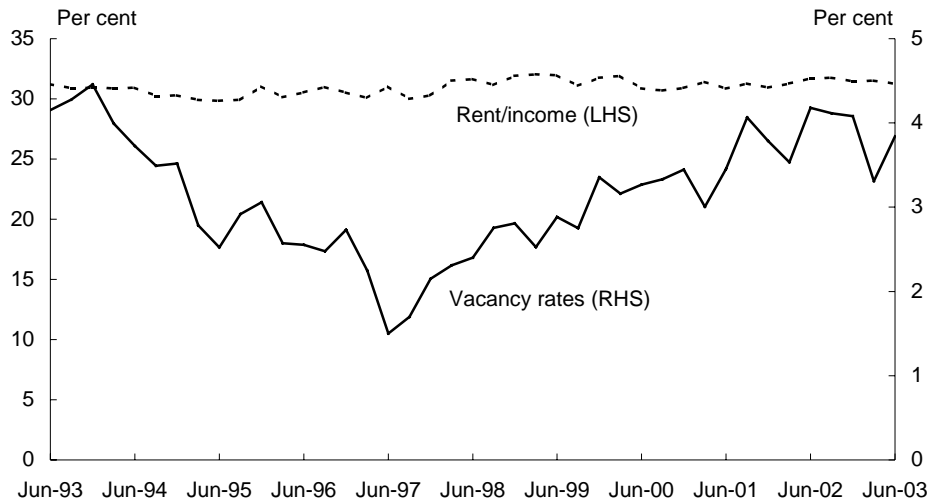
Income

Rental income is one of the key long run determinants of investor demand for housing. Rental income allows investors to service higher levels of debt, and provides a large proportion of those investors with a strong second income. That said, it is not necessary that investors enter the housing market solely for an income stream. As is the case with many types of shares, an investor may trade off high income (yield) against capital growth, depending on the particular financial situation of the investor. Cash flow analysis that ignores the capital growth component of an investment can therefore be misleading.

Rents over the past seven years have increased in-line with incomes rather than house prices. This may reflect the rise in vacancy rates over the past six years, thereby limiting the ability of landlords to increase rents (Chart 7). However, the budget constraint of households are likely to be a constraining determinant on rent, and this combined with the lags in the rental market and price stickiness of rents, suggests that rents are likely to adjust slowly to vacancy rates or may not adjust at all to temporary movements.

10 ABS Australian Social Trends 2003 Housing — Housing Stock: Changes in Australia's housing.

Chart 7: Detached house rent as a proportion of income and vacancy rates



Source: REIA Market Facts and ABS 6302.0

The ability of investors to service their housing investment debt depends also on their personal income levels. Personal incomes have risen strongly in recent years (up 34 per cent over the past five years) principally due to strong employment growth. Employment has grown at an annual average rate of around 2 per cent since 1997-98 and the unemployment rate has fallen to below 6 per cent (October 2003). The sustained improvement in the unemployment rate has contributed to the higher confidence and willingness of investors to hold higher levels of debt, as they feel more secure about their financial future and more able to withstand any temporary shock to their rental income stream.

The relative strength of the property market appears to be particularly important to Australia's aging population. People without substantial superannuation, or those wishing to top up their savings for retirement, appear to have been attracted by the strong capital gains available from investment in property.

Low interest rates

Interest rates play an important role in investor demand for housing by influencing the cost of capital. The standard variable mortgage interest rate has fallen from a high of 17.0 per cent in the late 1980s to average around 6.8 per cent over the past five years.

Financial deregulation of the 1980s has increased competition between lenders and reduced lending margins of financial intermediaries leading to further reductions of interest rates faced by borrowers. Of the 8 percentage point reduction in the average

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mortgage rate between the late 1980s and the past five years, about 2 percentage points can be attributed to the lower lending margins.¹¹

As mortgage interest rates halved, households' ability to service their borrowing nearly doubled. However, since mortgages are held for a considerable period of time (up to 30 years in some cases), borrowers need to consider a longer time horizon with respect to interest rates. Although expectations about the level of interest rates have been considerably lowered — through the effective control of inflation and the impact of financial deregulation over the past decade — investors need to consider that mortgage interest rates are currently at very low levels by historical standards and as such may not stay at these low levels over the life of the investment.

Alternative investments

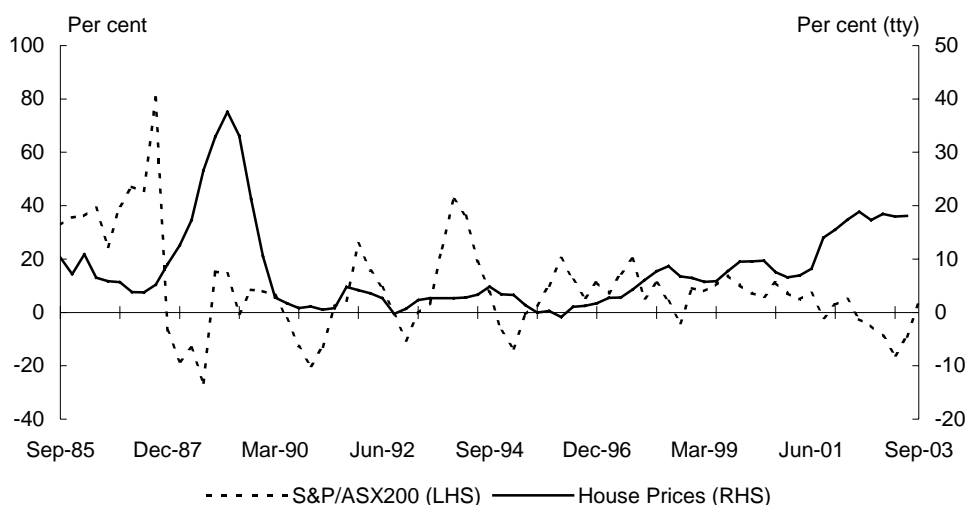
The poor performance of the stock market in recent years also provided an impetus to invest in housing. Low yields, high volatility, and capital losses in recent years appear to have made the stock market a less attractive option in which to invest for average households. Over 2002-03 the ASX 200 fell significantly (19 per cent between January 2002 and February 2003) (Chart 8). The perceived higher risk of investing in the stock market, be it capital losses or price movements volatility, also means households may have become less willing to borrow to invest in the stock market. Dwelling investment is typically perceived as a safe haven investment (bricks and mortar) and recent strong capital gains have reinforced this perception.

When choosing between alternatives, investors are influenced by comparisons of the overall after-tax rate of return. In this context, taxes from all levels of government, as well as income and asset tests through the social security system, can influence the choice of investments. For instance, Australia has a long tradition of providing concessionary taxation treatment to owner-occupied housing.

Key taxation factors that can influence the choice of investments include the overall personal income tax scales (including tax thresholds and marginal tax rates), the timing of assessing income and deductions, the treatment of inflation, the capital gains tax, the general tax principle that allows losses from one area of income to be offset against other forms of income (including negative gearing on borrowings) and depreciation arrangements. Many of these longstanding taxation treatments apply equally between investment options, such as that between an individual investor in housing or the stock market, and it is therefore difficult to state that they have favoured any particular asset class or that it has contributed to any excessive activity in any particular market.

11 Reserve Bank Bulletin March 2003, Household debt, what the data show, p. 3.

Chart 8: Share market and house prices



Source: RBA Bulletin.

Financial deregulation

In addition to lowering interest rates as a result of greater competition over the past decade, financial deregulation of the 1980s has led to greater availability of finance for investment in houses.

Within this new regulatory framework¹², lenders became more willing to provide finance for housing investment over the course of the 1990s. Prior to 1996, banks put more onerous conditions on investors than owner occupiers, charging around 1 percentage point above the usual lending interest rate.¹³ Specialist mortgage originators, lacking a customer base when they entered the market, competed aggressively with established lenders — a number charging the same interest rates for investors as they did for owner occupiers.¹⁴ Established lenders followed suit and the interest rate surcharge for investors was reduced.

The development of the mortgage broker business further added to competition by making it easier for borrowers to compare prices and products and increased demand

12 The major parts of the current regulatory framework that touch on mortgage lending include: the States and Territories regulate credit and consumer lending through the Uniform Consumer Credit Code; the Australian Securities and Investments Commission has some limited powers in relation to the conduct of credit providers (for example, in relation to misleading and deceptive conduct); and the Australian Prudential Regulation Authority prudentially supervises banks, building societies and credit unions.

13 Reserve Bank Bulletin December 2002, Innovations in the provision of finance for investor housing, p. 2.

14 Ibid.

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for investment in housing generally through advertising campaigns.¹⁵ Increased competition has led to the development of lending products with investors in mind including: home equity loans, split purpose loans, deposit bonds, zero deposit loans and redraw facilities.

Conclusion

There are many participants in the housing market — first home buyers, investors and those upgrading their home. All play an important role in the housing market and have contributed to the current housing boom. However, investors have come to play an increasingly significant role over the past decade.

Investor demand has been driven by a variety of factors in recent years and it is unlikely that any one of these factors alone can explain the strength in investor demand.

¹⁵ Ibid.

Australian net private wealth

Treasury has published annual estimates of Australian net private sector wealth since the *Summer 1990 Economic Roundup*. This article updates previous estimates and provides preliminary estimates for net private sector wealth as at June 2003.

The market value of Australian net private sector wealth grew by 12.8 per cent in the year to 30 June 2003. In real terms (that is, after allowing for inflation¹), wealth grew by 10.2 per cent. Real wealth per capita grew by 8.9 per cent.

1 The consumption deflator is used for this purpose.

Wealth definitions and uses

From an economic perspective, wealth can be defined as 'a store of spending power that can be carried into the future' (Jones and Perkins 1986, p. 150). Therefore, wealth includes a wide variety of assets, both financial assets, such as cash, shares and bonds, and non-financial assets, such as dwellings, factories and other business assets that can be used to generate future income.

Measurements of the *store* (or 'stock') of spending power, such as wealth, complement measurements of the *production* (or 'flow') of income, such as gross domestic product (GDP). Wealth thus provides a useful additional measure of living standards as well as a benchmark for examining trends in such aggregates as external liabilities and private sector debt. In addition, wealth appears to be a significant determinant of current and future aggregate private consumption.

Wealth can also include a variety of other less tangible assets that are sometimes referred to as 'human wealth'. Human wealth includes, for example, the skills, education and social structures, that contribute to an individual's capacity to generate income in the future. In addition, a broader definition of wealth might include such assets as natural resources or even leisure time or aesthetic qualities.

The change in real net wealth of households from one period to the next is the pure economic definition of saving.² Therefore, the annual change in real private sector wealth can be interpreted as the annual economic saving of the private sector.

Measuring wealth

From a practical perspective, some components of wealth can be extremely difficult to quantify. In particular, it is difficult to value those assets that are not readily tradeable and hence for which there are no readily observable prices. This is often the case for the various components of human wealth and some natural resources. As a result, the estimates in this article relate only to financial assets and non-financial (or physical) assets in those cases where there are well-developed markets and observable prices.

The scope of the estimates presented in this article is the Australian private sector. This consolidation of the private household and business sectors greatly simplifies the calculation of private sector wealth.³ However, this consolidation does result in a loss

2 See the article, 'The Measurement of Saving in Australia', in the *Spring 1999 Economic Roundup*.

3 Consolidating the private household and business sectors implies that the bulk of financial instruments held by households (such as bank deposits, debt instruments and superannuation) are netted out in the analysis.

of detail on the liabilities of these two sectors. Consequently, the data on asset types contained in the attached tables and charts should not be used to infer relative ownership by either the household or business sectors, or the level of personal wealth.⁴

A number of assumptions and approximations are required to construct these estimates, particularly for the latest year where much of the data remain provisional. Together with inevitable revisions to historical data, these limitations imply that the estimates should be interpreted as indicative of trends and broad orders of magnitude, rather than precise estimates.

The Australian Bureau of Statistics (ABS) also publishes estimates of wealth. The Appendix has a discussion of the relationship between the ABS and Treasury estimates.

Methodology — How is wealth measured?

The wealth estimates presented in this article are a measure of the value of net domestic and foreign assets owned by the Australian private sector. These estimates are constructed using the inventory approach⁵, largely following the methodology of Callen (1991). This approach involves aggregating across different asset types and adjusting for the public and/or foreign ownership⁶ of assets. The estimates are largely based on ABS estimates of the dwelling stock, business capital stock,⁷ stock of consumer durables and Australia's international investment position. Reserve Bank of Australia (RBA) data are used for holdings of public securities and RBA liabilities. Some private sector data and estimates from previous studies also enter the estimates.

Treasury estimates of net private sector wealth are calculated on both a market value and replacement cost basis. The market value of an asset represents the value that would be obtained if assets were to be sold in current market conditions. For example, dwelling wealth will move with house prices while business wealth will move with stock market prices. In contrast, the replacement cost of an asset is the cost of reproducing that asset. That is, it is the price that would have to be paid for an

4 Details on assets by sector are available in the ABS publication *Australian National Accounts: National Balance Sheet* (ABS Catalogue No. 5241.0), and Bacon (1998) discusses household wealth estimates in detail.

5 Other approaches for constructing estimates of wealth include the portfolio and estate methods. Piggott (1987) provides a useful summary of these approaches.

6 The wealth estimates presented in this article measure wealth owned by Australians, regardless of where that wealth is located. For example, an Australian-owned factory located overseas contributes to Australian net private wealth, while an overseas-owned factory located in Australia does not.

7 Business capital stock includes both rural and non-rural assets.

Australian net private wealth

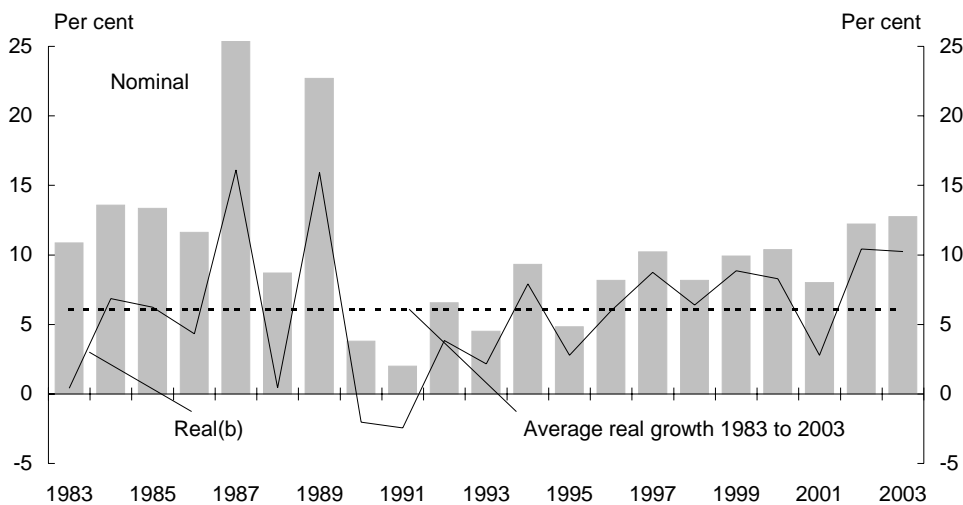
identical asset which is in the same condition and expected to yield the same flow of services as the original asset. It is the relevant concept for physical assets such as consumer durables, the stock of dwellings and the business capital stock. The equivalent concept for financial assets is the face value, which in the case of debt, for example, represents the price (excluding any accrued interest or dividends) which the borrower promises to repay the lender on expiry of the loan.

Detailed wealth estimates since 1960 are presented in the attached tables.

Movements in Australian private sector wealth in 2003

Through the year to 30 June 2003, Australian net private sector wealth at market value grew by 12.8 per cent in nominal terms, 10.2 per cent in real terms and 8.9 per cent in real per capita terms. The growth rate in nominal net private sector wealth during the year to June 2003 was the highest for more than a decade (Chart 1). The tables in the Appendix provide further details.

Chart 1: Growth in Australian net private sector wealth at market value^(a)



(a) Over the year to 30 June.

(b) Real wealth is determined using the consumption deflator. This includes the transitional impacts of *The New Tax System*.

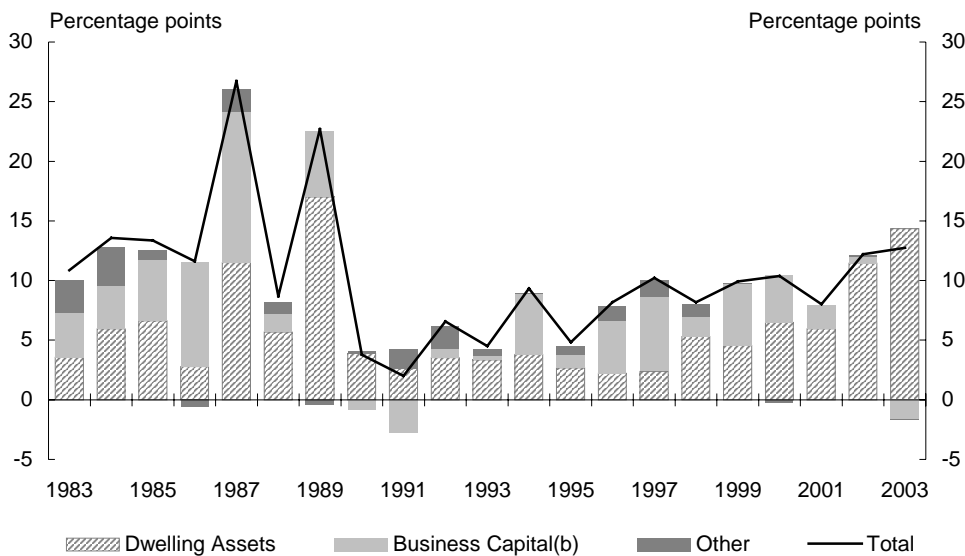
Source: Treasury.

In current prices, Australian net private sector wealth was approximately \$4,379 billion at market value as at 30 June 2003. This represents around \$219,900 per capita and 5.8 times the value of Australia's annual nominal GDP. Real net wealth per capita has increased for twelve consecutive years and has risen by over \$59,000 in the past five years alone.

In the year to June 2003, growth in the market value of dwelling assets dominated growth in all other forms of assets, contributing 14.3 percentage points to the growth in private wealth, more than double the long-term average contribution to growth of 5.8 percentage points (see Chart 2). The strong growth in dwelling wealth is a direct result of rapid house price increases throughout the country. The ABS House Price Index reported a broad-based rise in established house prices of 18.1 per cent in the year to June 2003.

The other main influence on wealth over the period was business assets (net of Australian investment abroad and foreign liabilities), which subtracted 1.6 percentage points. This is well below the long-term average contribution to growth of 3.1 percentage points and is the first time that business assets have subtracted from growth since 1991. The fall in business assets coincided with large declines in the value of the stock market. The ASX 200 fell by 9 per cent over the year to June 2003 but recovered by 8.1 per cent in the four months to October 2003. Movements in non-rural business assets, which make up over 80 per cent of total business assets, reflect changes in stock market prices and are, therefore, quite volatile.⁸

Chart 2: Contributions to growth in nominal Australian net private sector wealth at market value^(a)



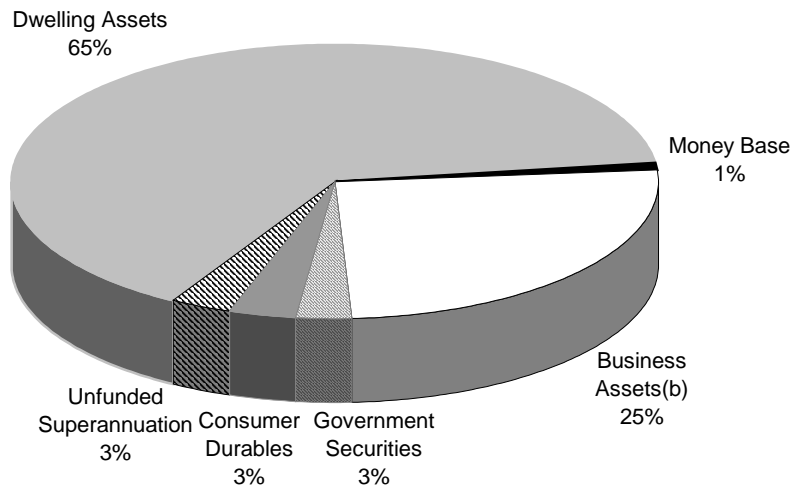
(a) Over the year to 30 June.
 (b) Includes Australian investment abroad and excludes foreign liabilities.
 Source: Treasury.

⁸ It is assumed that the market valuation of listed and non-listed companies move together.

Composition of Australian net private wealth by asset type

The composition of wealth at market value by asset type shifted slightly during the year to 30 June 2003 (Chart 3). Dwelling assets comprised a greater proportion of Australian net private sector wealth (up 7 per cent) while the share of business assets declined (down 5 per cent).

Chart 3: Composition of Australian net private sector wealth by asset type^(a)



(a) The components do not necessarily sum to 100 per cent due to rounding.

(b) Includes Australian investment abroad and excludes foreign liabilities.

Source: Treasury

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Appendix

Relationship with the ABS national balance sheets

The Treasury net wealth estimates presented in this article are broadly consistent with those published in the ABS publication, *Australian National Accounts: National Balance Sheet* (ABS Cat. No. 5241.0.40.001). The main differences are that the scope of the Treasury estimates is the aggregate private sector and that the Treasury estimates are prepared using a consistent basis for valuing the assets. In addition, the Treasury estimates are available for a much longer time period, thus allowing longer-term analysis of past changes in wealth.

In terms of scope, the Treasury estimates cover the total private sector in Australia. In contrast, the ABS balance sheets are prepared for a range of institutional sectors and for Australia as a whole, but not for the private sector as such. In terms of the ABS institutional sector classifications, the private sector is the sum of the ABS household and unincorporated enterprise sector and the private sector components of each of the non-financial corporation and financial corporation sectors.

In terms of scope, the major difference is that the ABS estimates include the value of demonstrated sub-soil assets and timber in native forests. These assets are not included within the Treasury estimates for two reasons. First, the ABS estimates for these assets typically only go back to 1989; the Treasury wealth estimates are calculated for each year back to 1960. Second, the valuation of these assets is difficult. The ABS valuations involve 'calculating the expected future net income flow generated by the asset, and then discounting at some interest rate for the life of the asset'. These figures cannot easily be added to the Tables below, since it is unclear to what extent these assets are already included in the valuations of businesses. In addition, comparisons with pre-1989 data will obviously not be possible.

Another important difference between the ABS and Treasury estimates is the valuation basis that is used. As noted earlier in this article, the Treasury estimates are compiled on both a market value and replacement cost basis. In contrast, the ABS uses a replacement cost basis for produced assets and a market value basis for financial assets and liabilities. As a result, the ABS estimates of 'net worth' (or wealth) are actually based on a mix of these two valuation methodologies.

Table A: ABS valuations of sub-soil and native timber assets

| As at | | |
|---------|----------------|------------------------|
| June | Subsoil assets | Native standing timber |
| 1989 | 62.5 | 1.2 |
| 1990 | 52.3 | 1.3 |
| 1991 | 56.7 | 1.7 |
| 1992 | 56.0 | 1.5 |
| 1993 | 66.9 | 1.7 |
| 1994 | 72.6 | 1.9 |
| 1995 | 93.6 | 2.1 |
| 1996 | 95.7 | 2.1 |
| 1997 | 114.3 | 2.2 |
| 1998 | 127.7 | 2.2 |
| 1999 | 139.8 | 2.2 |
| 2000 | 160.5 | 2.4 |
| 2001 | 197.1 | 2.7 |
| 2002 | 239.2 | 2.5 |
| 2003(a) | 262.3 | 2.8 |

(a) Preliminary figures.

Source: ABS Cat. No. 5204.0.

It is possible to reconcile the main components of the Treasury estimates of wealth at replacement cost with the estimates of produced assets in the ABS balance sheets, although allowance needs to be made for the differences in scope and coverage. While it is not generally possible to derive estimates of wealth at market value from the ABS balance sheets, it is possible to infer an estimate of the valuation ratio (the ratio of the market value of an asset to its replacement cost) for business assets. This is because the net financial assets held by the combined household and unincorporated, general government and foreign sectors (valued at market prices) should represent claims over the net physical assets held by the financial and non-financial corporation sectors (valued at replacement cost). The ratio so derived is reasonably similar to the valuation ratio for business assets which can be derived from the data presented in this article, thus confirming that, apart from the scope and coverage issues noted above, the Treasury wealth estimates are broadly consistent with the ABS estimates in the national balance sheets.

The ABS has also commenced publishing experimental wealth distributional data.

Australian net private wealth

Table A1(a): Nominal private sector wealth at market value

| As at June | Dwelling assets | Business assets | Consumer durables | Government securities | Money base | Australian Investment abroad | Foreign liabilities | Total wealth | Wealth per person |
|---------------|--------------------|--------------------|----------------------|--------------------------|---------------|------------------------------------|------------------------|-----------------|-------------------------|
| (\$ billion) | | | | | | | | | (\$'000) |
| 1960 | 21.6 | 28.3 | 5.3 | 7.4 | 1.8 | 0.4 | -3.5 | 63.2 | 6.0 |
| 1961 | 23.3 | 30.2 | 5.6 | 7.5 | 1.7 | 0.5 | -3.1 | 67.8 | 6.3 |
| 1962 | 25.8 | 31.3 | 5.5 | 8.3 | 1.8 | 0.5 | -3.3 | 72.2 | 6.6 |
| 1963 | 27.1 | 33.9 | 5.8 | 9.3 | 1.8 | 0.7 | -4.1 | 76.8 | 6.9 |
| 1964 | 31.2 | 38.8 | 6.0 | 9.8 | 2.1 | 0.8 | -5.4 | 86.0 | 7.6 |
| 1965 | 34.0 | 38.3 | 6.4 | 10.0 | 2.1 | 0.7 | -4.8 | 89.7 | 7.8 |
| 1966 | 36.1 | 41.7 | 6.7 | 10.8 | 1.9 | 0.9 | -5.1 | 96.3 | 8.1 |
| 1967 | 37.7 | 43.7 | 7.0 | 11.7 | 2.1 | 0.9 | -6.0 | 100.7 | 8.4 |
| 1968 | 41.4 | 62.1 | 7.5 | 12.3 | 2.2 | 1.4 | -9.3 | 121.6 | 9.9 |
| 1969 | 46.7 | 69.5 | 8.1 | 13.0 | 2.4 | 1.4 | -10.5 | 135.0 | 10.8 |
| 1970 | 53.9 | 68.6 | 8.8 | 12.5 | 2.7 | 1.5 | -10.1 | 142.9 | 11.2 |
| 1971 | 61.5 | 69.5 | 9.8 | 13.7 | 2.8 | 1.9 | -11.2 | 153.5 | 11.7 |
| 1972 | 70.8 | 80.0 | 10.7 | 16.2 | 3.0 | 2.5 | -14.5 | 175.0 | 13.2 |
| 1973 | 86.3 | 81.2 | 12.0 | 16.5 | 4.0 | 2.2 | -14.8 | 194.4 | 14.4 |
| 1974 | 113.4 | 81.1 | 14.2 | 14.5 | 4.5 | 2.0 | -13.0 | 224.7 | 16.4 |
| 1975 | 128.6 | 75.5 | 17.5 | 17.3 | 4.1 | 2.5 | -13.2 | 241.7 | 17.4 |
| 1976 | 147.8 | 89.1 | 21.2 | 20.1 | 5.1 | 2.9 | -18.9 | 278.2 | 19.8 |
| 1977 | 164.6 | 94.8 | 24.5 | 21.7 | 6.3 | 3.8 | -20.1 | 308.4 | 21.7 |
| 1978 | 176.8 | 106.7 | 27.3 | 25.9 | 5.9 | 4.5 | -22.1 | 339.7 | 23.7 |
| 1979 | 199.7 | 124.2 | 29.1 | 29.1 | 6.4 | 5.7 | -25.4 | 385.7 | 26.6 |
| 1980 | 232.9 | 166.9 | 32.9 | 30.5 | 6.9 | 6.5 | -34.3 | 461.9 | 31.4 |
| 1981 | 277.8 | 202.5 | 36.7 | 33.3 | 7.6 | 6.8 | -42.1 | 545.4 | 36.5 |
| 1982 | 302.3 | 189.0 | 41.7 | 34.5 | 8.7 | 8.7 | -48.8 | 562.9 | 37.1 |
| 1983 | 322.3 | 220.8 | 46.6 | 44.3 | 9.1 | 10.8 | -61.3 | 624.0 | 40.5 |
| 1984 | 359.4 | 249.4 | 49.8 | 60.1 | 10.2 | 12.6 | -69.3 | 708.7 | 45.5 |
| 1985 | 406.4 | 300.4 | 54.6 | 59.6 | 11.8 | 18.0 | -89.4 | 803.3 | 50.9 |
| 1986 | 428.7 | 377.2 | 62.3 | 45.8 | 13.0 | 30.4 | -108.5 | 896.7 | 56.0 |
| 1987 | 532.0 | 509.8 | 69.5 | 54.7 | 14.1 | 44.4 | -142.2 | 1136.3 | 69.9 |
| 1988 | 596.7 | 530.0 | 74.3 | 59.0 | 15.8 | 58.1 | -158.7 | 1235.1 | 74.7 |
| 1989 | 806.9 | 619.8 | 79.4 | 47.8 | 16.7 | 70.2 | -192.9 | 1515.3 | 90.1 |
| 1990 | 865.9 | 623.0 | 86.3 | 42.7 | 17.7 | 76.5 | -215.3 | 1572.7 | 92.2 |
| 1991 | 907.1 | 599.0 | 89.2 | 64.3 | 18.7 | 75.9 | -233.6 | 1604.1 | 92.8 |
| 1992 | 963.6 | 616.5 | 92.2 | 90.5 | 19.1 | 90.4 | -253.0 | 1709.3 | 97.7 |
| 1993 | 1020.6 | 622.5 | 95.9 | 94.6 | 20.5 | 111.6 | -274.2 | 1786.4 | 101.1 |
| 1994 | 1088.6 | 727.5 | 99.4 | 90.9 | 22.0 | 135.2 | -311.6 | 1953.1 | 109.4 |
| 1995 | 1141.0 | 758.0 | 105.4 | 98.0 | 23.5 | 152.9 | -338.6 | 2047.5 | 113.3 |
| 1996 | 1186.5 | 868.6 | 109.6 | 116.8 | 24.5 | 162.3 | -367.4 | 2214.7 | 120.9 |
| 1997 | 1239.4 | 1027.2 | 109.9 | 136.9 | 34.1 | 198.7 | -423.6 | 2441.1 | 131.8 |
| 1998 | 1369.0 | 1095.3 | 114.6 | 160.2 | 31.4 | 258.2 | -509.7 | 2640.7 | 141.1 |
| 1999 | 1489.5 | 1267.7 | 117.9 | 158.3 | 31.8 | 284.4 | -571.5 | 2902.9 | 153.4 |
| 2000 | 1677.8 | 1406.2 | 121.1 | 153.4 | 28.1 | 381.3 | -691.5 | 3204.4 | 167.3 |
| 2001 | 1868.3 | 1514.8 | 128.7 | 144.1 | 29.6 | 421.8 | -777.6 | 3461.3 | 178.3 |
| 2002 | 2264.9 | 1560.4 | 134.2 | 136.7 | 34.9 | 423.3 | -805.9 | 3884.0 | 197.5 |
| 2003 (a) | 2821.9 | 1536.3 | 140.9 | 127.2 | 35.0 | 430.1 | -851.2 | 4379.4 | 219.9 |

(a) Preliminary figures.

Table A1(b): Contribution to nominal private sector wealth at market value

| As at June | Dwelling assets | Business assets | Consumer durables | Government securities | Money base | Australian Investment abroad | Foreign liabilities | Total wealth |
|---------------|--------------------|--------------------|----------------------|--------------------------|---------------|------------------------------------|------------------------|-----------------|
| 1960 | | | | | | | | |
| 1961 | 2.7 | 3.0 | 0.5 | 0.2 | -0.2 | 0.2 | 0.6 | 7.3 |
| 1962 | 3.7 | 1.6 | -0.1 | 1.2 | 0.1 | 0.0 | -0.3 | 6.5 |
| 1963 | 1.8 | 3.6 | 0.4 | 1.4 | 0.0 | 0.3 | -1.1 | 6.4 |
| 1964 | 5.3 | 6.4 | 0.3 | 0.7 | 0.4 | 0.1 | -1.7 | 12.0 |
| 1965 | 3.3 | -0.6 | 0.5 | 0.2 | 0.0 | -0.1 | 0.7 | 4.3 |
| 1966 | 2.3 | 3.8 | 0.3 | 0.9 | -0.2 | 0.2 | -0.3 | 7.4 |
| 1967 | 1.7 | 2.1 | 0.3 | 0.9 | 0.2 | 0.0 | -0.9 | 4.6 |
| 1968 | 3.7 | 18.3 | 0.5 | 0.6 | 0.1 | 0.5 | -3.3 | 20.8 |
| 1969 | 4.4 | 6.1 | 0.5 | 0.6 | 0.2 | 0.0 | -1.0 | 11.0 |
| 1970 | 5.3 | -0.7 | 0.5 | -0.4 | 0.2 | 0.1 | 0.3 | 5.9 |
| 1971 | 5.3 | 0.6 | 0.7 | 0.8 | 0.1 | 0.3 | -0.8 | 7.4 |
| 1972 | 6.1 | 6.8 | 0.6 | 1.6 | 0.1 | 0.4 | -2.1 | 14.0 |
| 1973 | 8.9 | 0.7 | 0.7 | 0.2 | 0.6 | -0.2 | -0.2 | 11.1 |
| 1974 | 13.9 | -0.1 | 1.1 | -1.0 | 0.3 | -0.1 | 0.9 | 15.6 |
| 1975 | 6.8 | -2.5 | 1.5 | 1.2 | -0.2 | 0.2 | -0.1 | 7.6 |
| 1976 | 7.9 | 5.6 | 1.5 | 1.2 | 0.4 | 0.2 | -2.4 | 15.1 |
| 1977 | 6.0 | 2.0 | 1.2 | 0.6 | 0.4 | 0.3 | -0.4 | 10.9 |
| 1978 | 4.0 | 3.9 | 0.9 | 1.4 | -0.1 | 0.2 | -0.6 | 10.1 |
| 1979 | 6.7 | 5.2 | 0.5 | 0.9 | 0.1 | 0.4 | -1.0 | 13.5 |
| 1980 | 8.6 | 11.1 | 1.0 | 0.4 | 0.1 | 0.2 | -2.3 | 19.8 |
| 1981 | 9.7 | 7.7 | 0.8 | 0.6 | 0.2 | 0.1 | -1.7 | 18.1 |
| 1982 | 4.5 | -2.5 | 0.9 | 0.2 | 0.2 | 0.3 | -1.2 | 3.2 |
| 1983 | 3.6 | 5.6 | 0.9 | 1.7 | 0.1 | 0.4 | -2.2 | 10.9 |
| 1984 | 5.9 | 4.6 | 0.5 | 2.5 | 0.2 | 0.3 | -1.3 | 13.6 |
| 1985 | 6.6 | 7.2 | 0.7 | -0.1 | 0.2 | 0.8 | -2.8 | 13.3 |
| 1986 | 2.8 | 9.6 | 1.0 | -1.7 | 0.1 | 1.5 | -2.4 | 11.6 |
| 1987 | 11.5 | 14.8 | 0.8 | 1.0 | 0.1 | 1.6 | -3.8 | 26.7 |
| 1988 | 5.7 | 1.8 | 0.4 | 0.4 | 0.1 | 1.2 | -1.5 | 8.7 |
| 1989 | 17.0 | 7.3 | 0.4 | -0.9 | 0.1 | 1.0 | -2.8 | 22.7 |
| 1990 | 3.9 | 0.2 | 0.5 | -0.3 | 0.1 | 0.4 | -1.5 | 3.8 |
| 1991 | 2.6 | -1.5 | 0.2 | 1.4 | 0.1 | 0.0 | -1.2 | 2.0 |
| 1992 | 3.5 | 1.1 | 0.2 | 1.6 | 0.0 | 0.9 | -1.2 | 6.6 |
| 1993 | 3.3 | 0.4 | 0.2 | 0.2 | 0.1 | 1.2 | -1.2 | 4.5 |
| 1994 | 3.8 | 5.9 | 0.2 | -0.2 | 0.1 | 1.3 | -2.1 | 9.3 |
| 1995 | 2.7 | 1.6 | 0.3 | 0.4 | 0.1 | 0.9 | -1.4 | 4.8 |
| 1996 | 2.2 | 5.4 | 0.2 | 0.9 | 0.0 | 0.5 | -1.4 | 8.2 |
| 1997 | 2.4 | 7.2 | 0.0 | 0.9 | 0.4 | 1.6 | -2.5 | 10.2 |
| 1998 | 5.3 | 2.8 | 0.2 | 1.0 | -0.1 | 2.4 | -3.5 | 8.2 |
| 1999 | 4.6 | 6.5 | 0.1 | -0.1 | 0.0 | 1.0 | -2.3 | 9.9 |
| 2000 | 6.5 | 4.8 | 0.1 | -0.2 | -0.1 | 3.3 | -4.1 | 10.4 |
| 2001 | 5.9 | 3.4 | 0.2 | -0.3 | 0.0 | 1.3 | -2.7 | 8.0 |
| 2002 | 11.5 | 1.3 | 0.2 | -0.2 | 0.2 | 0.0 | -0.8 | 12.2 |
| 2003 (a) | 14.3 | -0.6 | 0.2 | -0.2 | 0.0 | 0.2 | -1.2 | 12.8 |

(a) Preliminary figures.

Australian net private wealth

Table A1(c): Real private sector wealth at market value^(a)

| As at June | Dwelling assets | Business assets | Consumer durables | Government securities | Money base | Australian Investment abroad | Foreign liabilities | Total wealth |
|----------------------|--------------------|--------------------|----------------------|--------------------------|---------------|------------------------------------|------------------------|-----------------|
| (\$ 2001-02 billion) | | | | | | | | |
| 1960 | 218.2 | 285.9 | 53.5 | 74.7 | 18.2 | 4.0 | -35.4 | 638.4 |
| 1961 | 226.2 | 293.2 | 54.4 | 72.8 | 16.5 | 4.9 | -30.1 | 658.3 |
| 1962 | 250.5 | 303.9 | 53.4 | 80.6 | 17.5 | 4.9 | -32.0 | 701.0 |
| 1963 | 260.6 | 326.0 | 55.8 | 89.4 | 17.3 | 6.7 | -39.4 | 738.5 |
| 1964 | 294.3 | 366.0 | 56.6 | 92.5 | 19.8 | 7.5 | -50.9 | 811.3 |
| 1965 | 309.1 | 348.2 | 58.2 | 90.9 | 19.1 | 6.4 | -43.6 | 815.5 |
| 1966 | 316.7 | 365.8 | 58.8 | 94.7 | 16.7 | 7.9 | -44.7 | 844.7 |
| 1967 | 319.5 | 370.3 | 59.3 | 99.2 | 17.8 | 7.6 | -50.8 | 853.4 |
| 1968 | 342.1 | 513.2 | 62.0 | 101.7 | 18.2 | 11.6 | -76.9 | 1005.0 |
| 1969 | 370.6 | 551.6 | 64.3 | 103.2 | 19.0 | 11.1 | -83.3 | 1071.4 |
| 1970 | 408.3 | 519.7 | 66.7 | 94.7 | 20.5 | 11.4 | -76.5 | 1082.6 |
| 1971 | 436.2 | 492.9 | 69.5 | 97.2 | 19.9 | 13.5 | -79.4 | 1088.7 |
| 1972 | 472.0 | 533.3 | 71.3 | 108.0 | 20.0 | 16.7 | -96.7 | 1166.7 |
| 1973 | 536.0 | 504.3 | 74.5 | 102.5 | 24.8 | 13.7 | -91.9 | 1207.5 |
| 1974 | 616.3 | 440.8 | 77.2 | 78.8 | 24.5 | 10.9 | -70.7 | 1221.2 |
| 1975 | 595.4 | 349.5 | 81.0 | 80.1 | 19.0 | 11.6 | -61.1 | 1119.0 |
| 1976 | 593.6 | 357.8 | 85.1 | 80.7 | 20.5 | 11.6 | -75.9 | 1117.3 |
| 1977 | 596.4 | 343.5 | 88.8 | 78.6 | 22.8 | 13.8 | -72.8 | 1117.4 |
| 1978 | 593.3 | 358.1 | 91.6 | 86.9 | 19.8 | 15.1 | -74.2 | 1139.9 |
| 1979 | 612.6 | 381.0 | 89.3 | 89.3 | 19.6 | 17.5 | -77.9 | 1183.1 |
| 1980 | 645.2 | 462.3 | 91.1 | 84.5 | 19.1 | 18.0 | -95.0 | 1279.5 |
| 1981 | 705.1 | 514.0 | 93.1 | 84.5 | 19.3 | 17.3 | -106.9 | 1384.3 |
| 1982 | 698.2 | 436.5 | 96.3 | 79.7 | 20.1 | 20.1 | -112.7 | 1300.0 |
| 1983 | 674.3 | 461.9 | 97.5 | 92.7 | 19.0 | 22.6 | -128.2 | 1305.4 |
| 1984 | 707.5 | 490.9 | 98.0 | 118.3 | 20.1 | 24.8 | -136.4 | 1395.1 |
| 1985 | 749.8 | 554.2 | 100.7 | 110.0 | 21.8 | 33.2 | -164.9 | 1482.1 |
| 1986 | 739.1 | 650.3 | 107.4 | 79.0 | 22.4 | 52.4 | -187.1 | 1546.0 |
| 1987 | 840.4 | 805.4 | 109.8 | 86.4 | 22.3 | 70.1 | -224.6 | 1795.1 |
| 1988 | 871.1 | 773.7 | 108.5 | 86.1 | 23.1 | 84.8 | -231.7 | 1803.1 |
| 1989 | 1113.0 | 854.9 | 109.5 | 65.9 | 23.0 | 96.8 | -266.1 | 2090.1 |
| 1990 | 1127.5 | 811.2 | 112.4 | 55.6 | 23.0 | 99.6 | -280.3 | 2047.8 |
| 1991 | 1129.6 | 746.0 | 111.1 | 80.1 | 23.3 | 94.5 | -290.9 | 1997.6 |
| 1992 | 1169.4 | 748.2 | 111.9 | 109.8 | 23.2 | 109.7 | -307.0 | 2074.4 |
| 1993 | 1210.7 | 738.4 | 113.8 | 112.2 | 24.3 | 132.4 | -325.3 | 2119.1 |
| 1994 | 1274.7 | 851.9 | 116.4 | 106.4 | 25.8 | 158.3 | -364.9 | 2287.0 |
| 1995 | 1310.0 | 870.3 | 121.0 | 112.5 | 27.0 | 175.5 | -388.7 | 2350.7 |
| 1996 | 1334.6 | 977.1 | 123.3 | 131.4 | 27.6 | 182.6 | -413.3 | 2491.2 |
| 1997 | 1375.6 | 1140.1 | 122.0 | 151.9 | 37.8 | 220.5 | -470.1 | 2709.3 |
| 1998 | 1494.5 | 1195.7 | 125.1 | 174.9 | 34.3 | 281.9 | -556.4 | 2882.9 |
| 1999 | 1610.3 | 1370.5 | 127.5 | 171.1 | 34.4 | 307.5 | -617.8 | 3138.3 |
| 2000 | 1779.2 | 1491.2 | 128.4 | 162.7 | 29.8 | 404.3 | -733.3 | 3398.1 |
| 2001 | 1885.3 | 1528.6 | 129.9 | 145.4 | 29.9 | 425.6 | -784.7 | 3492.7 |
| 2002 | 2249.2 | 1549.6 | 133.3 | 135.7 | 34.7 | 420.4 | -800.3 | 3857.0 |
| 2003 (b) | 2739.7 | 1491.6 | 136.8 | 123.5 | 34.0 | 417.6 | -826.4 | 4251.8 |

(a) Real wealth is calculated by dividing nominal wealth by the private consumption deflator.

(b) Preliminary figures.

Table A1(d): Real private sector wealth per person at market value^(a)

| As at June | Dwelling assets | Business assets | Consumer durables | Government securities | Money base | Australian Investment abroad | Foreign liabilities | Total wealth |
|---------------------------------|--------------------|--------------------|----------------------|--------------------------|---------------|------------------------------------|------------------------|-----------------|
| (\$ per capita, 2001-02 prices) | | | | | | | | |
| 1960 | 20825 | 27284 | 5110 | 7134 | 1735 | 386 | -3374 | 60932 |
| 1961 | 21113 | 27365 | 5074 | 6796 | 1540 | 453 | -2809 | 61435 |
| 1962 | 22956 | 27850 | 4894 | 7385 | 1602 | 445 | -2936 | 64242 |
| 1963 | 23430 | 29309 | 5015 | 8041 | 1556 | 605 | -3545 | 66400 |
| 1964 | 25954 | 32277 | 4991 | 8152 | 1747 | 665 | -4492 | 71541 |
| 1965 | 26729 | 30109 | 5031 | 7861 | 1651 | 550 | -3773 | 70517 |
| 1966 | 26775 | 30928 | 4969 | 8010 | 1409 | 668 | -3783 | 71424 |
| 1967 | 26534 | 30756 | 4927 | 8235 | 1478 | 633 | -4223 | 70874 |
| 1968 | 27899 | 41848 | 5054 | 8289 | 1483 | 943 | -6267 | 81944 |
| 1969 | 29573 | 44011 | 5129 | 8232 | 1520 | 887 | -6649 | 85489 |
| 1970 | 31896 | 40595 | 5208 | 7397 | 1598 | 888 | -5977 | 84563 |
| 1971 | 33380 | 37722 | 5319 | 7436 | 1520 | 1031 | -6079 | 83313 |
| 1972 | 35478 | 40088 | 5362 | 8118 | 1503 | 1253 | -7266 | 87693 |
| 1973 | 39691 | 37345 | 5519 | 7589 | 1840 | 1012 | -6807 | 89408 |
| 1974 | 44910 | 32118 | 5624 | 5743 | 1782 | 792 | -5148 | 88989 |
| 1975 | 42854 | 25159 | 5832 | 5765 | 1366 | 833 | -4399 | 80543 |
| 1976 | 42298 | 25499 | 6067 | 5752 | 1460 | 830 | -5409 | 79617 |
| 1977 | 42022 | 24202 | 6255 | 5540 | 1608 | 970 | -5131 | 78734 |
| 1978 | 41318 | 24936 | 6380 | 6053 | 1379 | 1052 | -5165 | 79388 |
| 1979 | 42200 | 26246 | 6149 | 6149 | 1352 | 1205 | -5367 | 81505 |
| 1980 | 43903 | 31462 | 6202 | 5749 | 1301 | 1225 | -6466 | 87071 |
| 1981 | 47248 | 34441 | 6242 | 5664 | 1293 | 1157 | -7160 | 92760 |
| 1982 | 45979 | 28747 | 6343 | 5247 | 1323 | 1323 | -7422 | 85616 |
| 1983 | 43804 | 30009 | 6333 | 6021 | 1237 | 1468 | -8331 | 84807 |
| 1984 | 45412 | 31513 | 6293 | 7594 | 1289 | 1592 | -8756 | 89549 |
| 1985 | 47493 | 35105 | 6381 | 6965 | 1379 | 2104 | -10447 | 93875 |
| 1986 | 46144 | 40601 | 6706 | 4930 | 1399 | 3272 | -11679 | 96519 |
| 1987 | 51675 | 49519 | 6751 | 5313 | 1370 | 4313 | -13812 | 110373 |
| 1988 | 52691 | 46802 | 6561 | 5210 | 1395 | 5131 | -14014 | 109065 |
| 1989 | 66193 | 50844 | 6513 | 3921 | 1370 | 5759 | -15824 | 124305 |
| 1990 | 66069 | 47536 | 6585 | 3258 | 1351 | 5837 | -16428 | 119999 |
| 1991 | 65357 | 43159 | 6427 | 4633 | 1347 | 5469 | -16831 | 115577 |
| 1992 | 66843 | 42765 | 6396 | 6278 | 1325 | 6271 | -17550 | 118571 |
| 1993 | 68528 | 41797 | 6439 | 6352 | 1376 | 7493 | -18411 | 119947 |
| 1994 | 71392 | 47711 | 6519 | 5961 | 1443 | 8867 | -20435 | 128088 |
| 1995 | 72487 | 48155 | 6696 | 6226 | 1493 | 9714 | -21511 | 130077 |
| 1996 | 72888 | 53359 | 6733 | 7175 | 1505 | 9970 | -22570 | 136051 |
| 1997 | 74284 | 61565 | 6587 | 8205 | 2044 | 11909 | -25389 | 146308 |
| 1998 | 79875 | 63906 | 6686 | 9347 | 1832 | 15065 | -29739 | 154073 |
| 1999 | 85082 | 72413 | 6735 | 9042 | 1816 | 16245 | -32645 | 165818 |
| 2000 | 92895 | 77857 | 6705 | 8493 | 1556 | 21111 | -38286 | 177418 |
| 2001 | 97114 | 78739 | 6690 | 7490 | 1539 | 21925 | -40419 | 179917 |
| 2002 | 114385 | 78806 | 6778 | 6904 | 1763 | 21378 | -40701 | 196155 |
| 2003 (b) | 137591 | 74907 | 6870 | 6202 | 1707 | 20971 | -41503 | 213532 |

(a) Real wealth is calculated by dividing nominal wealth by the private consumption deflator.

(b) Preliminary figures.

Australian net private wealth

Table A2: Nominal private sector wealth at replacement cost

| As at June | Dwelling assets | Business assets | Consumer durables | Government securities | Money base | Australian Investment abroad | Foreign liabilities | Total wealth | Wealth per person |
|---------------|--------------------|--------------------|----------------------|--------------------------|---------------|------------------------------------|------------------------|-----------------|-------------------------|
| (\$ billion) | | | | | | | | | (\$'000) |
| 1960 | 42.1 | 30.4 | 5.3 | 7.5 | 1.8 | 0.4 | -4.9 | 82.7 | 7.9 |
| 1961 | 44.9 | 33.4 | 5.6 | 7.7 | 1.7 | 0.5 | -4.2 | 89.7 | 8.4 |
| 1962 | 46.7 | 34.9 | 5.5 | 8.2 | 1.8 | 0.5 | -4.1 | 93.6 | 8.6 |
| 1963 | 49.3 | 37.3 | 5.8 | 8.9 | 1.8 | 0.7 | -5.2 | 98.5 | 8.9 |
| 1964 | 53.0 | 40.5 | 6.0 | 9.6 | 2.1 | 0.8 | -7.4 | 104.4 | 9.2 |
| 1965 | 57.5 | 43.3 | 6.4 | 10.1 | 2.1 | 0.7 | -5.5 | 114.6 | 9.9 |
| 1966 | 60.1 | 46.6 | 6.7 | 10.8 | 1.9 | 0.9 | -6.2 | 120.9 | 10.2 |
| 1967 | 62.4 | 48.8 | 7.0 | 11.6 | 2.1 | 0.9 | -7.4 | 125.5 | 10.4 |
| 1968 | 65.4 | 56.7 | 7.5 | 12.2 | 2.2 | 1.4 | -12.7 | 132.7 | 10.8 |
| 1969 | 68.2 | 61.5 | 8.1 | 13.2 | 2.4 | 1.4 | -14.2 | 140.5 | 11.2 |
| 1970 | 71.8 | 64.3 | 8.8 | 13.6 | 2.7 | 1.5 | -13.8 | 148.8 | 11.6 |
| 1971 | 76.6 | 69.1 | 9.8 | 14.6 | 2.8 | 1.9 | -14.6 | 160.1 | 12.3 |
| 1972 | 83.8 | 76.5 | 10.7 | 16.1 | 3.0 | 2.5 | -17.9 | 174.7 | 13.1 |
| 1973 | 93.5 | 82.0 | 12.0 | 17.3 | 4.0 | 2.2 | -18.9 | 192.1 | 14.2 |
| 1974 | 110.8 | 95.9 | 14.2 | 17.9 | 4.5 | 2.0 | -16.2 | 228.9 | 16.7 |
| 1975 | 131.7 | 110.9 | 17.5 | 20.3 | 4.1 | 2.5 | -11.3 | 275.8 | 19.9 |
| 1976 | 151.8 | 127.5 | 21.2 | 23.0 | 5.1 | 2.9 | -20.7 | 310.7 | 22.1 |
| 1977 | 172.5 | 143.5 | 24.5 | 25.3 | 6.3 | 3.8 | -19.3 | 356.7 | 25.1 |
| 1978 | 191.1 | 160.5 | 27.3 | 27.9 | 5.9 | 4.5 | -21.0 | 396.2 | 27.6 |
| 1979 | 207.6 | 180.3 | 29.1 | 32.4 | 6.4 | 5.7 | -27.1 | 434.3 | 29.9 |
| 1980 | 221.9 | 208.7 | 32.9 | 35.5 | 6.9 | 6.5 | -42.8 | 469.6 | 32.0 |
| 1981 | 252.9 | 236.2 | 36.7 | 39.4 | 7.6 | 6.8 | -52.0 | 527.6 | 35.4 |
| 1982 | 284.2 | 271.4 | 41.7 | 42.8 | 8.7 | 8.7 | -75.1 | 582.4 | 38.4 |
| 1983 | 307.4 | 299.2 | 46.6 | 50.9 | 9.1 | 10.8 | -92.7 | 631.2 | 41.0 |
| 1984 | 324.6 | 320.6 | 49.8 | 64.1 | 10.2 | 12.6 | -100.1 | 681.8 | 43.8 |
| 1985 | 368.8 | 358.6 | 54.6 | 64.1 | 11.8 | 18.0 | -115.9 | 760.0 | 48.1 |
| 1986 | 402.3 | 392.4 | 62.3 | 47.8 | 13.0 | 30.4 | -121.4 | 826.7 | 51.6 |
| 1987 | 457.0 | 435.3 | 69.5 | 57.0 | 14.1 | 44.4 | -137.6 | 939.7 | 57.8 |
| 1988 | 572.6 | 498.0 | 74.3 | 59.6 | 15.8 | 58.1 | -167.4 | 1110.9 | 67.2 |
| 1989 | 671.7 | 584.0 | 79.4 | 50.9 | 16.7 | 70.2 | -204.6 | 1268.2 | 75.4 |
| 1990 | 705.1 | 613.1 | 86.3 | 45.0 | 17.7 | 76.5 | -229.8 | 1313.9 | 77.0 |
| 1991 | 742.5 | 600.4 | 89.2 | 63.4 | 18.7 | 75.9 | -241.5 | 1348.5 | 78.0 |
| 1992 | 756.0 | 593.9 | 92.2 | 82.5 | 19.1 | 90.4 | -247.7 | 1386.5 | 79.3 |
| 1993 | 803.1 | 614.5 | 95.9 | 84.3 | 20.5 | 111.6 | -274.4 | 1455.4 | 82.4 |
| 1994 | 858.2 | 636.1 | 99.4 | 89.5 | 22.0 | 135.2 | -281.0 | 1559.4 | 87.3 |
| 1995 | 904.9 | 666.9 | 105.4 | 96.0 | 23.5 | 152.9 | -303.7 | 1645.9 | 91.1 |
| 1996 | 919.8 | 694.4 | 109.6 | 113.8 | 24.5 | 162.3 | -306.4 | 1718.0 | 93.8 |
| 1997 | 989.6 | 719.3 | 109.9 | 125.5 | 34.1 | 198.7 | -318.4 | 1858.7 | 100.4 |
| 1998 | 1055.6 | 758.3 | 114.6 | 137.8 | 31.4 | 258.2 | -366.5 | 1989.5 | 106.3 |
| 1999 | 1136.3 | 798.9 | 117.9 | 142.5 | 31.8 | 284.4 | -381.2 | 2130.5 | 112.6 |
| 2000 | 1233.5 | 842.0 | 121.1 | 142.7 | 28.1 | 381.3 | -430.3 | 2318.4 | 121.0 |
| 2001 | 1415.8 | 865.1 | 128.7 | 133.8 | 29.6 | 421.8 | -456.8 | 2538.0 | 130.7 |
| 2002 | 1464.3 | 890.8 | 134.2 | 130.4 | 34.9 | 423.3 | -473.3 | 2604.6 | 132.5 |
| 2003 (a) | 1528.9 | 930.5 | 140.9 | 118.5 | 35.0 | 430.1 | -520.0 | 2663.9 | 133.8 |

(a) Preliminary figures.

Globalisation: the role of institution building in the financial sector

G-20 Case study: an Australian perspective

In early April 2003, the G-20¹ invited members to prepare case studies on their experiences with financial sector institution building in order to provide lessons in attaining the benefits of globalisation. Australia was one of 15 members to submit a case study to the G-20. Australia's case study was prepared by Treasury with input from the Reserve Bank of Australia. It is anticipated that the G-20 case studies will also be made available by the current Secretariat (Mexico) on their G-20 website: www.hacienda.gob.mx/g20-2003.

1 The G-20 (Group of Twenty) comprises: Argentina, Australia, Brazil, Canada, China, France, Germany, India, Indonesia, Italy, Japan, Mexico, Korea, Russia, Saudi Arabia, South America, Turkey, United Kingdom, United States; and these international organisations: the International Monetary Fund (IMF), the World Bank and the European Union (EU).

Introduction

This paper provides a case study of the development of Australia's financial system and its experience in the past two decades with deregulation of the financial sector.

Financial liberalisation in Australia was an important driving force in providing a competitive stimulus to the financial sector, and enhancing technical, allocative and dynamic efficiency. It also provided benefits to the economy more broadly and provided the necessary conditions for Australia to become more closely integrated with the global economy, whilst accompanying parallel policy changes aimed at opening the economy to world markets.

While the deregulation process brought many benefits to Australia, the Australian experience suggests there are synergies in reform of different policy areas and gives insights into the appropriate sequencing of reforms.

The reform task is ongoing given the fast rate of change in global markets. The challenge for policymakers is to keep pace with market developments to ensure the regulatory environment continues to be relevant and appropriately balanced.

1. Historical review

The Australian financial system evolved in five stages. The first stage was the introduction of financial institutions during the early colonial period in the 19th Century, where the influence of British institutions was a key driving force. The end of that period was marked by a depression in the 1890s, which saw a major rationalisation of Australia's financial institutions. The start of the modern era of financial regulation can be traced back to the introduction of banking legislation in 1945 and the establishment of Australia's first central bank.

In more recent times, Australia has seen two major waves of financial reform. The first wave, in the 1970s and 1980s, involved a major deregulation exercise which transformed Australia's financial system. In keeping with other policy measures aimed at opening Australia to increased trade, investment and international competition. A second wave of reform in the 1990s sought to address new regulatory issues that arose in the post-deregulation period.

Financial sector reform did not occur in a vacuum but occurred in the context of a significant era of reform of the Australian economy. Reforms in other areas, and their relationship with the financial sector reforms, are also discussed in this section.

Foundations of the Australian financial sector

Origins of Australia's banking system

Australia's monetary and banking system originated in the 19th Century and was modelled on British laws and institutions. Commercial banking began in Australia in 1817 with the establishment of the privately-owned Bank of New South Wales, which issued legal tender. This was followed in 1819 by the first savings bank, the New South Wales Savings Bank, which held for safekeeping the moneys of new arrivals to the colonies (Peat Marwick 1985: 1).

The number of banks expanded over the course of the 19th Century, including in the new territories of Victoria and South Australia. British banks took the lead in expanding the financial system of the Australian colonies. They introduced large amounts of capital, provided channels for the inflow of British investment, established foreign exchange markets, encouraged interest rate competition, and began the development of a branch banking network.

Growth in the banking sector was driven in the first half of the century by rapid expansion of the pastoral industry. The discovery of gold in the 1850s in Victoria was a driving force behind growth in the second half of the century. This latter period resulted in the establishment of more than 30 new colonial banks and several British banks. By the 1890s, more than 1000 branches had been established and retail branch banking became widespread.

The 1890s depression provided a watershed period in the history of Australian banking. During the 1880s, Australia saw increases in investment associated with extraordinary levels of building activity and property market speculation. At the same time, banks took on higher levels of risk in order to maintain market share in the face of competition from non-bank financial institutions (NFBIs), such as building, pastoral and mortgage companies. Consequently, the collapse of the real estate market during the depression years led to a series of bank crashes and brought home to the banking industry the need for better prudential practices (Peat Marwick 1985: 1).

Between 1891 and 1893 only 10 out of 64 banks were not forced to close or refuse payment for longer or shorter periods (Gollan 1968: 28). The result was the rationalisation of the industry into a smaller number of viable banks. It also led to pressure for a national bank along the lines of the Bank of England and for a paper currency in order to stabilise and protect the financial system (Gollan 1968:18). However, action for a central bank would have to await Federation (Lewis and Wallace 1997: 49).

Globalisation: the role of institution building in the financial sector

Evolution of the central bank

With the Federation of the Australian states into the Commonwealth in 1901, the Commonwealth parliament assumed power to make laws with respect to banking and currency. In the two months following the inauguration of the Commonwealth, banks were invited to give their opinions on a banking act and in particular on control of note issue. The debate over establishing a national bank and its functions continued for the next decade as various models were considered.

The Commonwealth Bank was created in 1911 under the Commonwealth Bank Act. It was empowered to conduct both savings and general banking business supported by a Commonwealth Government guarantee. The Commonwealth Bank became the first bank involved in both trading and savings bank activities (Peat Marwick 1985:2). The Commonwealth Bank did not specifically have a central banking remit and it was not responsible for note issue, instead it was established as a vehicle to provide competition for commercial banks and to keep accounts of the Commonwealth Government.

The Government took over note issuance from the private banks in 1910 and transferred that responsibility to the Commonwealth Bank in 1924 (the function was managed by the Australian Treasury in the interim period). Increasingly, the Commonwealth Bank became banker to governments.

The plan had been to allow the Commonwealth Bank to evolve into a central bank as had the Bank of England. In 1924, under an amendment to the Commonwealth Bank Act, a Commonwealth Bank Board was established and the Bank was given the power to discount bills and to establish a discount rate. This was intended to provide the footings for central banking, despite it taking 50 years for the discount rate to become an instrument of monetary policy (Lewis and Wallace 1997: 49).

Australian banks fared better during the depression of the 1930s than the 1890s depression, with relatively few bank closures and consolidations. However, the 1930s depression did highlight the links between financial system stability and economic growth and employment. As a result, banking activities came under close scrutiny and there was a Royal Commission into Money and Banking in 1936-37. The Commission recommended a number of measures to support the stability of the financial system in Australia.

Most of these measures were adopted in the Bank Act and the Commonwealth Bank Act in 1945². The Commonwealth Bank was given powers to operate formally as a central bank by allowing it to fix interest rates, control lending of private trading banks and to demand that some of the private trading banks' funds be held with it. As well, the Commonwealth Bank Act regulated the spread of banks by making licensing mandatory (Peat Marwick 1985: 2).

In the ensuing period, tension emerged between the Commonwealth Bank's central bank role and its commercial role, with the private trading banks arguing that the Commonwealth Bank had an unfair advantage in the banking business. This eventually led to the separation of the Commonwealth Bank's trading and central banking activities, resulting in the formation of the Reserve Bank of Australia (RBA) in 1960, following the passage of the *Banking Act (1959)* and the *Reserve Bank Act (1959)*.

Origins of financial deregulation

The post-war regulatory system essentially sought to achieve its monetary and supervisory goals via direct restraints on the activities of banks. The regulatory regime that was in place during this period restricted banks' operational flexibility and their ability to compete. For example, interest rate ceilings on deposit accounts restricted banks' ability to attract funds. Similarly, lending was restricted through guidelines on trading bank approvals. Savings banks were constrained in their ability to lend for housing by the requirement to hold a majority of assets in cash, government securities or deposits with the central bank.

The role of NFBIs grew to fill the gaps caused by restraints on banks — for instance merchant banks to service corporations and building societies to service the home lending market. Not only did the market share of commercial banks decline over the period 1955 to 1980, but bank assets declined as a share of GDP. This had important implications for the conduct of monetary policy, which relied on direct controls on banks, and also caused concerns from a prudential perspective.

The Australian authorities were conscious of this trend at an early stage and a number of steps towards deregulation were taken during the 1960s and 1970s in an effort to bolster the position of banks and to begin to establish means by which influence could be exerted on the broader financial system. For instance, maximum rates on large overdrafts were removed in 1972 and interest rates on certificates of deposit were freed

2 There was a legal challenge to aspects of the legislation dealing with the ability of the central bank to be imposed as banker to state and local government authorities. When this challenge succeeded it called into question the legal basis of the legislation as a whole and led to the government seeking to nationalise the banks. It was ultimately defeated in this objective by a High Court challenge.

up in 1973, allowing banks some scope to manage their liabilities. However, regulation was very much focussed on the domestic market and competition among domestic institutions.

Freeing up regulation in some areas, however, had the effect of increasing pressures on the regulations that remained. By the 1970s, these pressures were being aggravated by the increasingly interest-sensitive nature of capital flows — largely reflecting the establishment of merchant bank subsidiaries of foreign banks, which had access to funds from their overseas parent organisations. These volatile capital flows, together with a pegged exchange rate, complicated efforts to control domestic liquidity and aggravated the effects of differential regulation between various parts of the financial system. The need for the central bank to fund any shortfall in raising government debt as a result of inefficient debt-raising mechanisms added to problems with liquidity management.

Against this background, the Government instigated a major review of the Australian financial system — the Campbell Committee Inquiry in 1979 — first major wave of financial sector reform. This Inquiry responded not just to the increasing importance of NBFIs and the difficulties with operating monetary policy, but also answered the need for a review and assessment of the range of regulatory changes that had occurred almost on an *ad hoc* basis during the 1960s and 1970s.

The Campbell Committee inquired into the regulation, control and structure of the financial system in order to promote efficiency, while at the same time ensuring the stability of the system. The Inquiry recommended the removal of regulation which undermined efficiency, such as interest rate controls and lending restrictions, and the strengthening of prudential oversight to bolster stability. In its report, the Campbell Committee argued that deregulation would increase efficiency of the financial system in three ways:

- it would improve *allocative efficiency* by removing the barriers to the flow of savings into the highest-yielding investments;
- it would increase *operational efficiency* by reducing the very wide interest rate margins maintained by the Australian banks; and
- it would enhance *dynamic efficiency* in the form of greater financial innovation to meet the needs of consumers of financial services.

The Committee suggested a number of reforms that included the removal of ceilings on interest rates on bank deposits, the lifting of maturity restrictions on bank deposits, the introduction of a tender system for selling government securities, the relaxation of portfolio controls on savings banks, relaxation of capital controls and removal of

restrictions on the entry of foreign banks. These recommendations were implemented in the first half of the 1980s.

A further recommendation of the Campbell Committee was the floating of the Australian dollar. At the time, there was increasing recognition in Australia and elsewhere, that it was not possible to pursue an independent monetary policy while defending a fixed exchange rate with mobile capital. This broader concern, in conjunction with short-term pressures associated with speculation against the Australian dollar, led to the floating of the currency in 1983.

As an entire generation had known only a highly-regulated environment, the Government understandably allowed time for the business community, bureaucracy and general community to absorb the Campbell Report. In 1983, the newly elected Labor Government adopted an investigation into the financial system having regard to the Campbell Report and the new government's economic and social objectives. The Report of the Martin Review Group strongly endorsed the major recommendations of the Campbell Committee and from then on the Government's commitment to deregulation was unreserved and, in rapid sequence, major recommendations of both of the reports were implemented (Lewis and Wallace 1997: 6).

Developments post-deregulation

The period of rapid deregulation in the first half of the 1980s sparked equally rapid change for Australia's financial sector. Over the period 1983 to 1988, the amount of capital in the sector rose from A\$4.5 billion to A\$20 billion, the number of banking groups operating in Australia rose from 15 to 34, and the number of merchant banks increased from 48 to 111.³ Credit also expanded rapidly, growing by 147 per cent between 1983 to 1988, but this brought with it some unanticipated problems.

The lowering of barriers to entry into financial markets increased competition, which in turn facilitated technological innovation and enhanced consumer choice. Deregulation helped improve the efficiency of the sector by focusing activity towards innovation and away from the unproductive activity of circumventing outdated regulations.

3 While one of the objectives of the Campbell Report was to put banks back on an equal footing with other financial institutions, some disadvantages remained for banks for some years, which may have influenced the growth in merchant banks. These disadvantages included requirements to hold statutory deposits with the central bank and a proportion of assets in notes and coin or government securities. The establishment of a merchant bank was also a popular means for foreign banks to establish a presence in Australia prior to the decision to allow foreign bank branches in 1992.

Globalisation: the role of institution building in the financial sector

Deregulation accelerated the forces of globalisation on the Australian market. While technological change lowered the costs of cross-border transactions, deregulation removed impediments to such transactions, allowing markets to become more global in nature. This added to the pace of change in financial markets.

These changes also created new challenges for regulators. Innovation in product design blurred the boundaries between financial instruments and institutions. With regulation still following largely institutional lines, providers were able to exploit regulatory gaps — for example there was a further proliferation of NFBIs offering savings products which had the competitive advantage of not being subject to the same stringent regulation as the banks. Moreover, non-financial service competitors, such as retailers, airlines and telecommunications companies, were entering the industry and offering financial services to consumers. These changes in the financial system led to products and distribution channels expanding beyond the traditional categories of banking, insurance and stock broking. This placed pressure on regulation to ensure competitive neutrality in the treatment of like products offered by different institutions.

Increasing consumer sophistication was associated with new products and, importantly, the greater availability of information about those products. This factor, together with demographic factors (such as the ageing of the population) and government initiatives to promote retirement savings, led to changing consumer demands. In particular, it saw a relative decline in the importance of deposits as a form of savings.

In addition to these broader forces of change, specific developments in the post-deregulation environment provided pressure for further review of the financial system.

The level of corporate gearing increased significantly over the 1980s. Underlying this trend was a rise in the number of highly leveraged corporate takeovers from 1984-87, while credit growth post 1987 was driven in large part by a property boom.

A number of factors contributed to lower credit quality. Banks took some time to adjust risk assessment procedures. In the deregulated environment, banks were able to take on higher risk borrowers and also needed to take account of exchange rate and interest rate risk to a greater degree than before (Valentine 1991). In addition, during the late 1980s high inflation, together with a taxation system that provided incentives to borrow to finance capital investments, led to large amounts of over-borrowing as investors took advantage of increasing asset prices.

As interest rates rose over the late 1980s, the fall in credit standards began to manifest itself in significantly higher levels of non-performing loans and write-downs, resulting

in substantial losses at two of the four largest banks, the recapitalisation or takeover of some State government owned banks, and the closure of some NBFIs.

Foreign banks also carried a significant level of non-performing loans during the recession of the early 1990s. The share of non-performing loans to total assets peaked at 12 per cent for the foreign bank sector, which was twice the peak in the broader system. The higher proportion of non-performing loans in the foreign bank sector, notwithstanding the experience of their parent institutions, suggest that actions of the domestic banks in protecting market share might have contributed to foreign banks taking on riskier business. The domestic banks began reacting to the possibility of competition from foreign banks through mergers, acquisitions and increased lending in the early 1980s, well before deregulation and before any foreign banks had actually entered the market.

Managing country currency risk

The move to a floating exchange rate in 1983 came in response to pressure from capital inflows, rather than capital outflows as is more frequently the case in other countries. Nevertheless, there was a learning phase for agents to recognise and manage currency mismatches.

Faced with new financial freedoms in the immediate post-float period, some agents began to borrow unhedged in foreign currencies to take advantage of significantly lower interest rates overseas. In particular, many farmers and small businesses borrowed substantial amounts in Swiss francs. When the exchange rate subsequently fell sharply, in 1985 and 1986 (by about 40 per cent), these borrowers faced large losses, and many went out of business.

The immediate issue that led to the problems of the Swiss franc loans was one of risk recognition. The Australian experience was that publicity surrounding the problems of farmers played an important role in educating the corporate sector more broadly about the risks and the need to manage them.

While Australia worked through this period without a full-blown banking crisis, the ramifications lasted for some years. The economy's recovery from the 1990-91 recession was slowed by the need for banks and corporates to repair their balance sheets. At the same time, the Australian Banking Industry Inquiry in 1991 was set up to examine concerns about the performance of the banking sector in a deregulated environment. As well as many recommendations with a competition focus, the report sought to strengthen the supervision of banks to address shortcomings that had been highlighted by the late 80s/early 90s episode.

Many issues raised throughout the 1980s and 1990s were overcome with the appropriate regulatory adjustments, such as the establishment of coordinated supervision of banks and NFBI, as well as the introduction of regulations into the insurance and superannuation industries. The financial system was transformed over this period and continued to undergo sweeping change. Against this background, the Government decided in 1996 to establish a new inquiry to review these developments, to consider the factors likely to drive further change in an increasingly more global environment, and to make recommendations for possible further improvements to the regulatory arrangements.

The policy response

Financial system reform — the second wave

In 1996, the Government commissioned the Financial System Inquiry, the Wallis Inquiry. The Inquiry was commissioned to make recommendations on regulatory arrangements that would respond to the developments of the previous decade and ensure an efficient, responsive, competitive and flexible financial system. Specifically, the underlying objectives of the Wallis Inquiry were:

- to promote greater efficiency through enhanced competition; and
- to maintain confidence and stability in the financial system while preserving the ability to be responsive to innovation and market developments.

The Inquiry found that the intensity of prudential regulation should be proportional to the degree of market failure which it addresses, but should not involve a government guarantee over any part of the financial system. Fundamentally, it is the responsibility of the board and management of financial institutions to ensure that the financial promises made to consumers are kept. Prudential regulation and supervision should seek only to add an additional discipline by promoting sound risk-management practices by firms and providing for early detection and resolution of financial difficulties.

The Inquiry considered that while prudential regulation is warranted in certain limited circumstances, its more intense forms would need to be wound back over time and the regulatory focus shifted towards the conduct of market participants and disclosure of information.

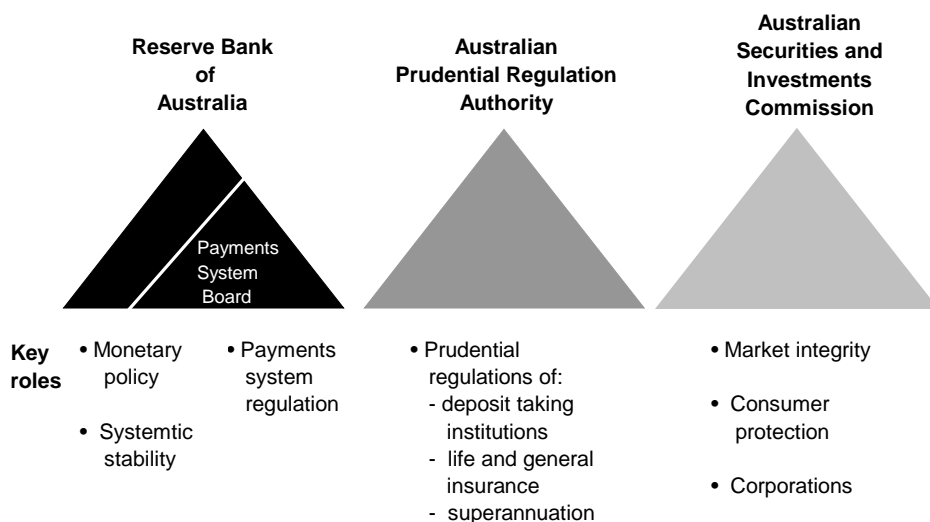
The financial regulation framework recommended by the Wallis Committee in its Final Report of March 1997 was intended to be flexible in the face of ongoing change in the financial sector. In general, this evolution in the market requires a shift in regulatory philosophy towards an increased reliance on disclosure and market-based signals and away from highly specialised prudential or industry-specific regulation.

Implementation of reforms

The Australian Government accepted a majority of the recommendations of the Wallis Inquiry (Costello 1997). The key recommendation was a new organisational framework for the regulation of the financial system. The Inquiry recommended a model of regulation based on functional objectives, with three 'peaks' — a single prudential regulator, a regulator for conduct and disclosure, and an institution responsible for systemic stability and payments. The regulatory framework prior to the Wallis Inquiry was based on a sectoral approach, where different regulatory institutions had responsibility for specific industries within the financial sector.

The reforms built upon the previous regulatory framework that was based on four institutional regulators and replaced them with three agencies established on functional lines, as can be seen in Figure 1.

Figure 1: Key regulatory agencies in Australia



Under the Wallis reforms, the **Reserve Bank of Australia (RBA)** is responsible for monetary policy, the overall stability of the financial system and the regulation of the payments system. The RBA focuses on maintaining stability in the financial system (including the payments system, which is an important contributor to stability). The RBA retained responsibility for systemic stability, as any system wide problems would likely require liquidity support by the monetary authorities. The RBA liaises extensively with the other financial sector regulators in monitoring systemic stability.

- The principal change to the RBA's functions was the removal of responsibility for prudential supervision of banks and depositor protection. This change assisted to clarify that while the RBA may intervene to assist systemic stability, its balance

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sheet was not available to guarantee deposits. It also clarified the accountabilities for the regulatory task.

The **Australian Prudential Regulation Authority (APRA)** became responsible for the prudential regulation of all deposit-taking institutions, general insurance, life insurance and superannuation. This resulted in all prudentially regulated entities in the financial system being brought within the Commonwealth jurisdiction and regulated by a single agency. This allowed for the removal of artificial and anti-competitive distinctions between different types of entities providing similar products and assisted the regulation of financial service conglomerates. Prior to the Wallis reforms, prudential regulation was carried out by several different agencies at both the Commonwealth and State government levels.

The **Australian Securities and Investments Commission (ASIC)** became responsible for maintaining market integrity, consumer protection, and the supervision of companies across the financial system. These responsibilities were transferred from several different regulators with the intention of minimising inefficiencies, inconsistencies and regulatory gaps that undermined effective competition in financial markets.

To effectively perform their role, the regulators were given substantial operational independence from the Government in administering legislation and in dealing with particular cases in prudential supervision or conduct and disclosure. The financial sector regulators have a clear charter of objectives and accountabilities laid out in their enabling legislation.

Accountability for the operational or day-to-day supervision of financial institutions and markets lies with the regulators. The roles of the Australian Government — through its ministers within the Treasury portfolio — includes setting the broad policy direction and priorities for regulation of the financial sector and bringing proposals to the Parliament for new legislation or amendments to legislation.

Additionally, in March 1998 the Government established a high level Financial Sector Advisory Council (FSAC). FSAC is a non-statutory body that brings together a range of financial market participants to provide advice to the Government on policies to facilitate the growth of a strong and competitive financial sector.

The move in Australia to match the structure of the regulators to their functional objective and to consolidate supervision of financial institutions is consistent with international developments. Amongst OECD countries, Canada, Denmark, Norway, Sweden and the United Kingdom moved in the late 1980s and early 1990s to establish a single prudential regulator separate from the central bank. The post-Wallis regulatory structure has also provided a model for changes in other countries. A number have

established a single financial sector regulator, while others have established arrangements similar to Australia.

Insurance sector reforms

Australian private sector general insurers are regulated by APRA under the *Insurance Act 1973* (the Insurance Act). Over time, the prudential arrangements set out under the Act were increasingly considered to be blunt and unresponsive in an environment of significant market and regulatory developments, including globalisation, convergence and improvements in domestic and international regulatory best practice. These changes had driven the need for more flexible and sophisticated ways for regulators to undertake prudential regulation of the general insurance sector. In 2000, the Government announced that the regulatory framework for the general insurance industry would be reformed. The new framework commenced on 1 July 2002, with capital requirements to be phased in by 1 July 2004.

The overarching objective in developing a new framework for the prudential supervision of general insurance was to provide a more secure environment for policyholders. The revised Insurance Act strengthens the requirements for general insurers to conduct insurance business and increases APRA's enforcement powers to undertake its regulatory responsibilities. Consistent with other financial sector reforms, the amendments are designed to ensure the Insurance Act is more flexible and less prescriptive than the earlier legislation, allowing the prudential regime more easily to accommodate market developments over time. The power for APRA to set standards provides for the framework to be responsive to changes in commercial and international best practice.

Broader policy environment

Reform of the financial sector cannot be fully understood without reference to the broader policy environment given the interactions between different strands of policy. For example, deregulation was in part aimed at making monetary policy more effective, but in the process led to fundamental changes in the way monetary policy was formulated and implemented. The removal of exchange rate and capital controls, was consistent with Australia's more outwardly-focused policy orientation. However, it put subsequent pressures on the current account and had implications for the appropriate stance of fiscal policy. Moreover, developments in the financial sector placed pressures on other areas of regulation, such as competition policy.

Monetary policy

During the late 1970s and early 1980s, monetary policy in Australia was guided by a target for annual growth in M3 (defined as currency plus all other bank deposits of the private non-bank sector), this target was referred to in the Australian context as a

'conditional projection'. This was in line with the practice in many other countries at the time. However, financial deregulation saw the demand for money, as traditionally defined, become increasingly unstable, and the relationship between monetary aggregates and inflation and nominal income break down. Monetary targeting was abandoned in 1985. In the absence of alternatives, this left monetary policy to be set on a discretionary basis for the next few years, although a 'checklist' of economic variables was adopted for a period.

The persistence of relatively high inflation in Australia through the late 1980s and the desire for a more credible and intellectually robust framework for monetary policy saw Australia adopt an inflation targeting regime in 1993. This took a less rigid form than some other countries, with the target specified as an inflation rate between two and three per cent on average over the economic cycle. This was affirmed in the *Statement on the Conduct of Monetary Policy* signed by the Treasurer and the Governor of the Reserve Bank of Australia in August 1996. The Statement also formally established the independence of the Reserve Bank.

There is little doubt that the additional market scrutiny that came with deregulation and increasing integration with global markets added to the pressure to get the monetary policy framework right. These same forces brought about equally dramatic changes in the Reserve Bank's operational framework, which in turn put in place the basis for greater operational independence. The freeing up of banks' activities meant the abandonment of many of the early tools of monetary policy — many of which were in the hands of the Government, rather than the central bank. In this new world it became possible for monetary policy to operate via open market operations aimed at setting the overnight cash rate. This, for the first time, provided a purely market-based mechanism for monetary policy, and one which was entirely in the hands of the central bank.

Fiscal policy

Following the floating of the Australian dollar and removal of capital controls there was increasing focus on the size of Australia's current account deficit, and the savings-investment imbalance underlying the deficit. There was much public debate on the 'twin deficits' of the current account and the federal budget and pressure for a medium term fiscal strategy that boosted public savings and reduced pressure on the current account.

Fiscal policy was also contributing to high domestic interest rates (Comley, *et al*, 2002) and making the economy more vulnerable to changes in investor confidence. Effectively, Commonwealth finances were seen as imposing a 'speed limit' on economic growth by creating negative perceptions about investment in Australia.

In the 1996-97 Budget the Commonwealth Government announced that it would implement a *Charter of Budget Honesty*. The charter was not to articulate any specific rules or objectives for fiscal policy but specified a number of transparency-oriented requirements and guiding principles for the operation of fiscal policy. In 1998, the Government adopted an explicit strategy to maintain budget balance, on average, over the course of the economic cycle.

Further, the Commonwealth Government undertook major reform of the taxation system in 2000 with the introduction of a 'goods and services tax' (GST) in July of that year based on the 'value added tax' model. The GST removed a number of inefficient specific taxes and provided a broad base indirect tax system to ensure a secure revenue base into the future. Reform of the taxation system has provided a more competitive and robust foundation in face of increasing global competition for investment (OECD 2000).

Review of the Commonwealth Government securities market

As a result of the medium-term fiscal strategy of maintaining budget balances, on average, over the course of the economic cycle (see Chart 1), combined with a program of privatisation, the Government since 1996 has significantly reduced its level of net debt. Net debt has fallen from a peak of 19.1 per cent of GDP or around A\$96 billion in 1995-96 to an estimated 4.3 per cent of GDP or around A\$32 billion in 2002-03. Net debt is expected to fall to 3.7 per cent of GDP or around A\$30 billion in 2003-04.

Reductions in gross debt outstanding have accompanied the decline in net debt. This is reflected principally in declining Commonwealth Government Securities (CGS) on issue (see Chart 2).

Chart 1: Commonwealth General Government — underlying cash balance

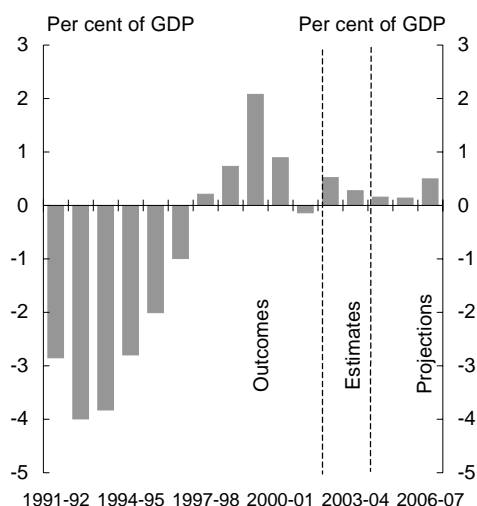
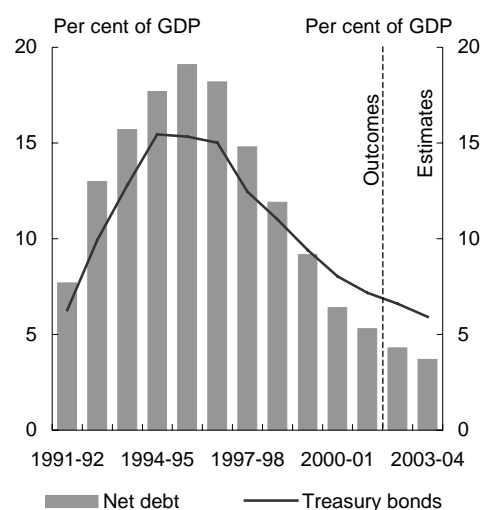


Chart 2: Commonwealth General Government net debt and Treasury bonds on issue



Source: The Treasury (2003), *Budget Strategy and Outlook 2003-04*: Budget Paper No. 1.

The reductions in CGS on issue raised questions among some market participants about the future viability of the CGS market. The Government acknowledged these concerns in the 2002-03 Budget and undertook to examine the issue in consultation with key stakeholders.

The Review concluded that, while financial markets may innovate in the absence of CGS, there was merit in maintaining CGS operations. It was identified, in particular, that the CGS market plays an important role in managing interest rate risk (the risk associated with adverse movements in interest rates), and contributes to a lower cost of capital in Australia. Further, in the absence of CGS, the Australian financial market may become less diversified and more vulnerable during periods of instability. Accordingly, on the basis of its findings, the Government announced as part of the 2003-04 Budget that it would maintain sufficient CGS on issue to support the Treasury bond futures market. As such, the gap between Treasury bonds on issue and net debt is likely to increase in the future.

Trade policy and competition policy

As noted, at the same time as it was deregulating its financial sector, Australia was reforming other sectors of its economy in response to the more outward-orientation of the domestic policy framework that began in the 1970s. The lowering of tariff barriers and rationalisation of industry assistance during the 1980s provided further impetus to the globalisation of the economy, and transformed the traded goods sector of the economy. As a result, Australia's trade intensity (exports plus imports of goods and

services as a proportion of GDP) rose from 30 per cent of GDP in 1983-84 to 43 per cent in 2001-02.

Increased international competition led to pressure for reform of the non-traded goods sectors of the economy, sectors which were important to international competitiveness as they supplied inputs to exporters. The National Competition Policy introduced in the 1990s brought together a range of reforms of key infrastructure at the Commonwealth and State levels to enhance competition and improve the regulation of monopolies.

Globalisation changed the nature and definition of markets, and this had particular implications for mergers policy. Mergers policy has increasingly had to recognise the importance of the level of import competition and international competitiveness of firms seeking to increase their market share. This has taken place in an environment where the general mergers policy has been overlaid with a 'four pillars' policy, which prohibits mergers between Australia's four major banks.

Taxation reform

Australia's business tax arrangements have been modernised and improved. The centrepiece of these reforms has been the significant reduction in company tax rates to an internationally competitive 30 per cent. Capital gains tax changes have provided further efficiencies by removing indexation and replacing it with a halved rate of tax for individuals and trusts and exempting one third of the gain for superannuation funds. As a further measure, tax rates for different financial institutions were aligned as part of the business tax reforms which started in 1999. These tax rate reductions were funded by complementary measures, such as the removal of accelerated depreciation, which broadened the business income tax base.

Australia recently made changes to its tax treaty with its most significant investment partner the United States through an amending Protocol which entered into force on the 12 May 2003. The Protocol provides opportunities to significantly enhance the international competitiveness of Australian businesses, further improve Australia's standing as a global financial centre and increase trade and investment flows between Australia and the United States.

The Protocol represents a significant advance in the provision of a competitive tax treaty network for companies located in Australia and investing in the United States, in particular, through the reductions it makes in rates of withholding taxes.

Other notable tax treaty developments recently undertaken by Australia include the update to the tax treaty with Canada, completion of a new tax treaty with Russia and completion of a Taxation Code as part of the Timor Sea Treaty with East Timor.

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Negotiations for a revised double tax convention between Australia and the United Kingdom are close to conclusion.

Corporate governance

In March 1997 the Government announced its Corporate Law Economic Reform Program (CLERP). The program was developed in response to two key factors that revealed inadequacies in corporate regulation at that time.

The first of these factors was the increasing globalisation of capital markets. Liberalisation of world capital markets in combination with technological developments in information and telecommunication industries have fundamentally altered the nature and operation of business and the financial system.

The worldwide liberalisation of trade and capital markets resulted in Australian firms being increasingly exposed to international competition and it was considered vital that Australia have a regulatory framework that permits business to respond to challenges posed by changes in the international marketplace. In addition, changes in investor behaviour, which were reflected in growing financial sophistication, required a reassessment of the regulatory framework.

The second closely related factor was the perception that Australia's business law had not kept pace with changes in the structure and operation of capital markets and business environment.

A review of Australia's corporate regulatory framework was considered necessary in order to ensure Australia's business laws were not placing undue compliance burdens on business in Australia. The evidence suggested that the existing framework constrained business activity and did not take account of the complexity facing management of large enterprises. The imposition of unnecessary costs inhibits business start-ups and development, and increases costs to business, investors and consumers alike.

In response, the CLERP reforms have facilitated business and financial markets through changes to the accounting standard setting infrastructure, financial product disclosure and licensing requirements, company takeovers as well as directors' duties and governance more generally. The CLERP process is ongoing, with changes currently planned in relation to corporate disclosure and insolvency rules.

One of the CLERP initiatives, the Financial Services Reform Act, put in place a harmonised licensing, disclosure and conduct framework for all financial products, markets and service providers. It is designed to develop a more efficient and flexible regime for financial products and markets within an integrated framework. This streamlined regulatory regime for financial markets and clearing and settlement

systems will improve information disclosure to investors and overtime will reduce administrative and compliance costs.

Companies that provide financial services need only one type of licence — an 'Australian Financial Service Licence'. The regime provides that financial services providers must be properly trained and must comply with high standards of disclosure. Through the combination of licensing, conduct and disclosure obligations, consumers are better protected and able to determine the basis for the financial advice they receive.

2. Benefits of reforms

Assessment of the economic benefits from reforms to financial regulation in Australia must be considered in the context of several factors.

First, deregulation did not occur in a policy vacuum — it is not possible to isolate the role of financial deregulation from other developments over the 1980s and 1990s which contributed to changes in the financial system. This includes the range of other policy reforms in Australia over the period and factors unrelated to regulatory reform, such as globalisation and the introduction of new technologies.

Secondly, the hard data required to assess the effects of deregulation are, in many cases, unavailable or incomplete. Therefore, the analysis often relies, of necessity, on more qualitative observation.

Finally, it is difficult to identify the benefits flowing from more recent reforms, such as those following the Wallis Inquiry and the changes to the regulation of general insurance. A number of these reforms have only recently come into effect or are set to come into effect in the near future.

The benefits flowing directly from the reform of financial regulation cannot be precisely identified or quantified in the Australian case given their integration with a wide range of other policy reforms aimed at opening up the Australian economy to international competitive forces. Nevertheless, it is clear that there have been improvements in financial sector performance over time. However, it should also be noted that the increases in competition that have flowed from some reforms have taken time to eventuate, particularly in the retail banking sector. The benefits that have been evident include improved efficiency by financial service providers and increased choice in financial services available to consumers. There is also evidence that the streamlining of the regulatory framework has reduced the relative cost burden of financial regulation.

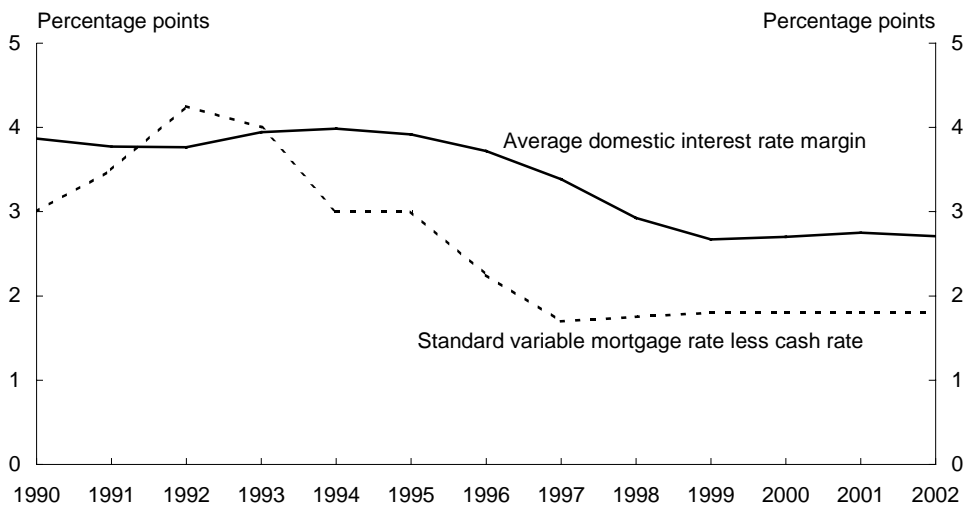
Increased competition

The reforms to financial regulation implemented over the past two decades have promoted competitive pressures across the financial sector. In particular, competition in markets, such as home and personal lending, has been enhanced by a number of changes. These include the entry of foreign banks into the Australian market and the establishment of specialist providers in the home lending market.

It should be noted that while the entry of foreign banks enhanced competition in wholesale markets they have struggled to make inroads in retail markets. In particular, it remains the case that the provision of finance to small businesses is concentrated in the four major banks. Also, increased competition in a number of instances took a while to come through — suggesting that it takes both deregulation and appropriate technology (which reduces the costs faced by new entrants) to produce an effective increase in competition.

Bank net interest rate margins provide an indication of overall profitability and the underlying level of competition. These margins are calculated as the difference between the average interest rate banks charge on their loans and the average rates they pay on their deposits. Over the past decade the net interest rate margin has fallen from around 4 percentage points to around 2¾ percentage points. The fall in the margin between rates for residential mortgages in Australia and short-term money market rates has been even more pronounced. The margin between these rates has declined from over 4 percentage points to around 1¾ percentage points (see Chart 3).

Chart 3: Bank net interest rate margins



Source: *Reserve Bank of Australia Bulletin* (2003), 'Banking fees in Australia'.

The rate of decline in these margins was most pronounced over the second half of the 1990s, largely as a result of heightened competition in the home lending market. The pressure on bank margins reflects falling barriers to entry facilitated by financial market and technological innovation which, among other things, provides non-bank competitors with alternative ways of financing their lending (that is, through securitisation), accessing customers and distributing products (Gizycki and Lowe 2000).

Efficiency benefits

There is evidence that the increase in competitive pressures that have flowed from the process of financial regulation reforms has contributed to improved efficiency in the financial sector over time. In particular, partial indicators point to gradual improvements in allocative and technical efficiencies in a number of sectors, including retail banking.

In the banking sector, prior to the Campbell regulatory reforms, interest rate and maturity controls resulted in a pricing structure under which most retail payments and transaction services were provided free of charge. The costs of these services were offset against lower interest rates on deposits. As a result of these controls, the banking system practiced considerable cross-subsidisation among different products and customer groups. These cross-subsidies created distortions in pricing signals.

During the 1990s, the pricing of these banking services began to reflect more closely the 'user pays principle', thus creating stronger incentives for allocative efficiency improvements. For example, an extensive range of fees and charges for retail transaction accounts has been introduced by institutions providing deposit-taking services. These fees and charges will improve allocative efficiency to the extent that they more closely reflect the underlying cost of providing the services.

The narrowing of bank interest rate margins has also contributed to improvements in allocative efficiency by ensuring that the price of loans more closely reflects the cost of funds. The benefits to customers from reductions in banks' interest rate margins over the past decade have more than outweighed the cost of fees and charges levied (RBA 2003).

There is also evidence that increased competition in the financial system has given financial service providers incentives to reduce production costs (increase technical efficiency). Developments in technical efficiency over time can be broadly approximated by changes to operating expenses of financial service providers.

The Wallis Inquiry noted that, notwithstanding the rise in financial assets as a share of GDP, the contribution of the financial sector to GDP has been declining. That is, the

financial sector has been managing a greater amount of assets with fewer resources. The Inquiry found that these declining costs are primarily due to lower employment in the financial sector, driven by technological restructuring and enhanced efficiency. Increased competition in the financial sector has provided an impetus for domestic institutions to reduce their costs of production.

As a result of increased efficiency, operating expenses of the domestic banks (as a proportion of total assets) have been gradually trending downwards from just over 3 per cent of total assets in 1987 to below 2½ per cent of total assets in 2002 (KPMG Financial Institutions Performance Survey 1995, 1996 and 2002). It should be noted that a range of factors beyond increased competitive pressures would have influenced operating expenses. For example, subdued wage inflation, strong asset growth and the sharp increase in the volume of high-value low margin business.

Deregulation has also seen significant 'dynamic efficiency' benefits from product innovation. Changes to financial regulation in the 1980s, such as the removal of controls on interest rates and term deposit products and the entry of foreign banks into the domestic market, increased both the range of products which banks could offer and the number of competitors in the finance sector. The competitive pressures on financial service providers to meet customer needs have been further enhanced by the arrival of niche, non-bank, service providers in several profitable markets. The improved range of products available to consumers is highlighted by developments in debt and credit products.

There have been considerable improvements in the range and sophistication of debt products available to consumers. During the 1980s deposit-taking institutions were the main source of home finance. These institutions offered, on average, two varieties of mortgage products, which had limited flexibility in terms and conditions. By 1996, consumers were able to choose from approximately 1,760 differentiated mortgage products offered by a range of suppliers. This figure includes a spectrum of residential, investment and equity mortgages offered by 150 financial institutions, each offering an average of 12 different mortgage products. Moreover, products available included elements such as fixed and variable interest rates, redraw facilities and arrangements for offsetting interest between savings and loan balances (RBA 2002).

There have been similar improvements in the deposit products available to consumers. Prior to regulatory reforms, deposit products available to consumers were limited to transaction accounts, savings accounts, savings bank investment accounts and term deposits. The introduction of cash management accounts during the 1980s substantially improved the rate of return available on short-term retail deposits. The choice of deposit products available to consumers has subsequently increased, with almost 1,800 different deposit accounts on offer at the end of 1996.

A further indicator of the improved services for consumers has been the diversification of delivery platforms for financial services. During the early 1980s, the predominant mechanism for delivery of financial services in Australia was the traditional branch network. However, over the late 1980s and 1990s this situation altered significantly as financial service providers quickly embraced the opportunities to improve services facilitated by the development of new technologies. The incentive to use these new technologies for service delivery primarily arose from the drive by financial service providers to reduce the costs of service delivery.

As shown in Table 1, there has been strong growth in the accessibility of financial services for consumers since 1997. In particular, there has been a decline in the number of physical access points such as branches and agencies. However, this trend has been more than offset by the strong growth in electronic access points such as Automatic Teller Machines (ATMs) and Electronic Funds Transfer at Point of Sale (EFTPOS). Australia's take-up of EFTPOS technology, in particular, is high by international standards.

Table 1: Access to financial services

| Method | Jun-98 | Jun-99 | Jun-00 | Jun-01 | Jun-02 |
|-------------------|---------|---------|---------|---------|---------|
| Bank branches | 6,121 | 5,358 | 5,003 | 4,712 | 4,728 |
| Non-bank branches | 1,391 | 1,358 | 1,208 | 1,428 | 1,236 |
| Bank agencies | 6,992 | 6,528 | 5,043 | * | * |
| Non-bank agencies | 1,760 | 1,417 | 887 | * | * |
| GiroPost | 2,627 | 2,724 | 2,814 | 2,814 | 2,962 |
| ATMs | 8,182 | 9,387 | 10,818 | 11,915 | 11,714 |
| EFTPOS | 164,199 | 265,391 | 320,372 | 362,848 | 402,084 |
| Total | 191,272 | 292,163 | 346,145 | 383,717 | 422,724 |

Source: APRA Points of Presence Survey, RBA Bulletin and APCA Payment Statistics.

* Relates to a break in the data series due to definitional changes.

The trends in the delivery of financial services in Australia reflect the broad trends worldwide.

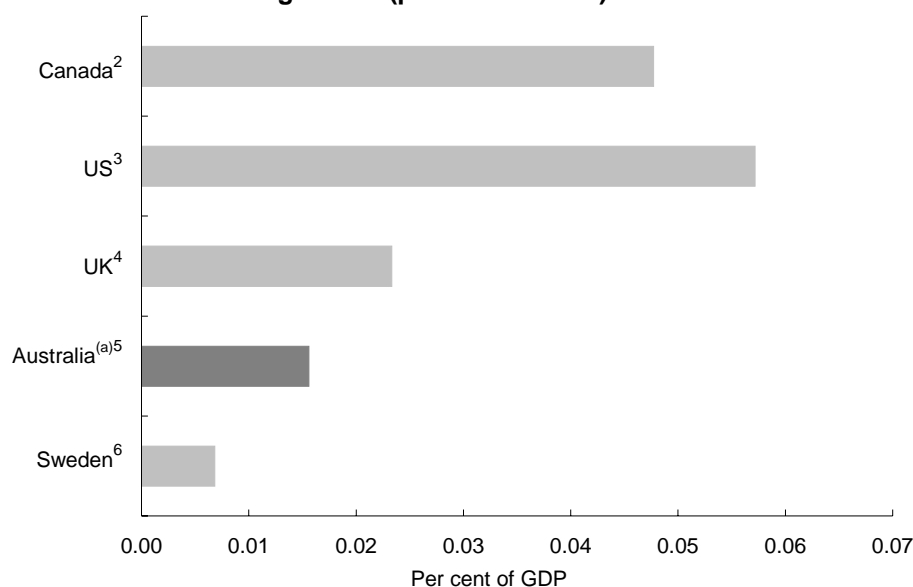
Reduced costs of regulation

Evidence compiled by the Wallis Inquiry indicated that the direct cost of regulation in Australia was relatively high compared to a sample of other jurisdictions. In part, these higher costs were attributed to new regulation introduced following the Campbell Report. Much of this regulation did not fully anticipate the pace of developments in financial markets.

More recent data on the direct costs of regulation indicate that costs in Australia relative to other selected countries have fallen (see Chart 4). The improvement in the direct cost of regulation likely reflects the streamlining of regulatory arrangements

following the Wallis Inquiry. The reforms made following Wallis were designed to ensure that the regulatory framework was coherent, duplication was minimised, and unnecessary imposts were eliminated.

Chart 4: International comparison of total direct costs of financial sector regulation (per cent of GDP)¹



1 Financial sector regulation refers to both prudential regulation and regulation of markets and securities. Country totals are not directly comparable because they have not been adjusted for differences in countries' financial industries, regulatory legislation and labour and other costs. They are also affected by relative strengths of countries' currencies against the sterling on the dates chosen for translation of local currency data into sterling.

2 The main costs of regulation in Canada come from the Office of Superintendent of Financial Institutions, Canadian Deposit Insurance Corporation, provincial regulators, the Canadian Investor Protection Fund and provincial insurance regulators.

3 The main costs of regulation in the US come from the Federal Reserve, regional reserve banks, The Federal Deposit Insurance Corporation, Office of Comptroller of the Currency, Treasury, state banking departments, Office of Thrift Supervision, Securities and Exchange Commission, Commodity Futures Trading Commission, self regulating institutions, state commissioners and the Department of Commerce.

4 The main costs of regulation in the UK come from the FSA and the Financial Services Ombudsman Scheme and the Financial Services Compensation Scheme.

5 The main costs of regulation in Australia come from APRA, ASIC and the Payments System Board (PSB) of the RBA.

6 The main costs of regulation in Sweden come from the Finansinspektionen.

Source: (a) 2001-02 Total cost (from Measure 1) of APRA, ASIC and PSB. Other data from FSA 2000-01 Annual Report and OECD Main Economic Indicators.

Output benefits

While it is difficult to identify separately benefits of individual reforms, the integration of Australia into the global economy coincided with strong improvements in productivity and income growth, both relative to historical growth and to the OECD average.

The Australian economy strengthened considerably in the 1990s with nine years of persistent growth. This strong performance included thirteen consecutive quarters of through the year growth above 4 per cent — the longest run of such growth recorded in the history of the quarterly National Accounts (since September 1956).

Table 2: Average annual growth rates, 1970-2000 — percentage change

| | GDP growth | | | | GDP growth per capita | | | |
|-----------|------------|-----------|-----------|-----------|-----------------------|-----------|-----------|-----------|
| | 1970-1980 | 1980-1990 | 1990-2000 | 1996-2000 | 1970-1980 | 1980-1990 | 1990-2000 | 1996-2000 |
| Australia | 3.2 | 3.2 | 3.5 | 4.2 | 1.5 | 1.7 | 2.3 | 3.0 |
| OECD(a) | 3.4 | 3.0 | 2.5 | 3.2 | 2.5 | 2.3 | 1.8 | 2.6 |

(a) Weighted average.

Source: OECD 'The sources of economic growth in OECD countries', 2003

Productivity performance

During the 1990s, productivity growth rates in Australia returned to levels not seen since the late 1960s. By the second half of the 1990s, Australia's average annual labour productivity growth was more than double that recorded in the late 1980s and exceeded the OECD average.

Similarly, Australia experienced strong growth in multi-factor productivity (MFP). The strong growth in MFP in the 1990s highlights the fact that Australia's productivity surge reflected underlying improvements in the overall efficiency of the economy. This reflects factors such as improving management and work practices within industries, and resource allocation into more productive industries.

Table 3: Productivity growth rates in Australia (annual average)

| | Labour | Multifactor |
|-----------------------------------|--------|-------------|
| Second half of the 1990s | 3.7 | 2.0 |
| 1990s | 2.9 | 1.4 |
| 1980s | 1.4 | 0.4 |
| 1970s | 2.8 | 1.3 |
| Long term average (since 1964/65) | 2.4 | 1.1 |

Source: The Australian Bureau of Statistics, Catalogue Number 5204.0.

Australia's strong productivity growth was a payoff from sustained macroeconomic and structural reforms. Indeed, the OECD, in its 2003 Economic Survey of Australia, noted that 'dogged pursuit of structural reforms across a broad front, and prudent macroeconomic policies set in a medium-term framework, have combined to make Australia one of the best performers in the OECD, and also one notably resilient to shocks, both internal and external'.

Recent Australian and US analysis, and new multi-country comparisons, have helped to further identify the reasons for this strong performance (Treasury 2003). In short, deregulation and strong competition drove new work practices and encouraged rapid

uptake of business-transforming information and communication technologies in a macroeconomic environment that supported steady growth and strong investment.

The cross-country evidence also shows that a sophisticated, effectively regulated financial sector is an important contributor to growth. As the OECD notes, 'there is growing evidence that a well developed financial system is an important aspect of a favourable environment for growth, especially in a period of the rapid spread of a new technology when they can promote new, innovative enterprises' (OECD 2003). The Australian experience with financial sector liberalisation, underpinned by stable and supportive macroeconomic policies and structural reforms, contributed to sustained economic growth and reduced Australia's susceptibility to economic shocks.

3. Lessons

Design of financial regulation framework

In evaluating the regulatory framework, a number of factors have been identified that influence the effectiveness of financial sector regulation and subsequent changes to regulation. In particular, Australia's experience suggests that:

- the effectiveness of the financial regulation framework is enhanced if the objectives of regulation are clearly defined and the framework can adjust to developments in the financial sector;
- a balance needs to be struck when determining the appropriate level of regulation and transparency, between achieving stability and security and the promotion of competition, innovation and efficiency;
 - this includes the need for the reporting requirements of financial institutions and the regulations governing the behaviour of the supervisory authorities to be consistent with the requirements of the relevant international standards and codes, to ensure international competitiveness and best practice;
- benefits of reforms to financial regulation may take some time to be realised and may require complementary reforms in many different areas and/or sectors; and
- once a reform process has begun, it gains its own momentum, and it is important that governments maintain an ongoing commitment to reform, including periodic reviews, which look at the operation of the financial system holistically so that the effects of *ad hoc* or piecemeal efforts can be assessed and revised as necessary to ensure complementarity.

The process of reforming the structure of financial regulation in Australia has highlighted the importance of ensuring that the objectives of regulation are clearly defined and the regulatory framework is sufficiently flexible to adjust to developments in the structure of the financial sector over time.

The recognition of the complexity and special nature of financial markets has led to the establishment of specialised regulatory arrangements for the financial sector in most countries. However, it is also important to recognise that the imposition of regulation on financial markets may restrict the ability of financial sector participants to operate efficiently, and potentially impede competitive pressures and innovation. Therefore, in designing financial regulation, a balance needs to be struck between achieving stability and integrity in the financial system and promoting financial markets that are competitive, efficient and innovative.

This trade-off between stability and efficiency, and its implications, has been highlighted by developments in financial regulation in Australia. The financial regulation framework in place up to the early 1980s relied heavily on the restriction of market forces to maintain financial market stability and security. While this approach was successful in maintaining stability, it also resulted in impediments to competition, reduced efficiencies (both in the market itself and the broader economy) and resulted in a lack of responsiveness to consumers — in short, it inhibited growth.

The changes subsequently made to financial regulation have shifted the focus from restricting market forces to less interventionist mechanisms — such as prudential standards and disclosure requirements. These changes assisted to increase competitive pressures by reducing barriers to entry and enhancing competitive neutrality between different entities providing similar services.

The degree of regulation has also been adjusted in recognition of the level of risk of market failure. For example, prudential regulation powers are strongest for deposit-taking institutions and less interventionist for investment products. The improvements in efficiency and innovation that have flowed from the regulatory changes introduced since the early 1980s have demonstrated the potential benefits of achieving a more appropriate balance between competition and stability.

The experience in Australia with financial regulation also highlights the importance of the regulatory framework being sufficiently flexible to accommodate developments in the structure of the financial sector and ensuring that any necessary regulatory response is systematic and complete.

Over the course of the 1980s and early 1990s the financial regulation framework required numerous adjustments to respond to innovations in financial services and the way these services were delivered. In particular, regulation was predominantly based

on the institutional form of the service provider and the traditional distinctions between markets and products. However, this approach did not adequately accommodate the increasing incidence of financial service conglomerates. The Wallis Inquiry found that while governments and agencies had identified trends in the evolving financial system, the regulatory response was often *ad hoc* and uncoordinated. This led to regulation arrangements that in some cases were inconsistent, resulted in regulatory gaps and was not conducive to effective competition in financial markets.

The shift in the basis of financial regulation from the institutional form of the service provider to a functional-based approach following the Wallis Inquiry has improved the flexibility of the regulatory framework. It has provided for a more coherent and streamlined approach to regulating financial service providers, including conglomerates. This has been reflected in improvements in the relative costs of regulation in Australia.

Financial stability lessons

Many of the financial stresses brought about by globalisation impact directly or indirectly on the financial system. Typically, currency mismatch problems, such as those discussed in Section 1, impact directly on the soundness of banks since the banking system frequently intermediates between foreign currency lenders and domestic firms. If hedging instruments are not available, the banking system either suffers directly through taking on the foreign currency risk itself or indirectly through the default of domestic firms that have borrowed from it in foreign currency. Maturity mismatches can also create severe liquidity problems for financial institutions. In addition, high levels of capital inflow or domestic credit growth following liberalisation often result in boom-bust cycles in asset prices, which once again put pressure on financial institutions via declining credit quality and the reduced value of collateral.

A precondition for weathering these stresses successfully is for the banking system to be well managed, well capitalised and well supervised. As discussed in Section 1, deregulation in Australia created pressures on the Australian financial system and highlighted weaknesses in bank management and prudential supervision which have subsequently been addressed.

Although the disruption to the banking system experienced in Australia was in many ways similar to that experienced in many countries opening up to foreign capital, and the institutional setting at the time was heavily influenced by the pressures of opening up markets, the specific pressures were largely driven by the freeing up of domestic credit. Nonetheless the implications for financial supervision are the same. This illustrates an important point — that sound institutions are necessary irrespective of globalisation, although globalisation may increase the costs of not having them.

While some areas in the Australia economy were not fully prepared for financial liberalisation — such as in the general understanding of foreign exchange risks — the economy was able to absorb the transition. This suggests that by the early 1980s, the economy had reached some critical thresholds.

We would argue that the most important thresholds were:

- the ability to manage currency mismatch, as Australian entities were able to borrow in domestic currency, both through domestic markets and offshore; and
- a sufficient soundness of the banking sector, which was therefore able to absorb the losses which arose at the end of the post-liberalisation boom in asset prices.

There is a difficult trade-off between institutional development and financial liberalisation. Liberalising before institutions are sufficiently sound can make the benefits from liberalisation ambiguous. On the other hand, liberalisation can hasten institutional development, for instance by knowledge transfer from foreign financial institutions participating in the local market.

These developments suggest that, even in relatively well-developed and deep markets like in Australia, currency volatility raises some important management issues for corporations. Such volatility may be more pronounced in less developed and less liquid markets.

- There are a variety of factors that could assist in smoothing the transition to a liberalised financial sector, the most important being the ability to borrow in domestic currency and the soundness of the banking system. Australia seemed to have reached or passed the thresholds in these areas by the early 1980s.

Broader policy lessons

The Australian experience has also demonstrated that reforms are inter-related. For example, the deregulation of the financial sector contributed to pressures to rethink the conduct of monetary and fiscal policy. It also placed pressures on other areas of regulation. This suggests the desirability of broad based reform which takes account of synergies between different policies at an early stage.

That said, there is no exact blueprint for reform and, politically, there are limits to the amount of reform that can be implemented at any one time. Governments must take opportunities as they arise as they can only realistically champion a small number of causes. Moreover, in the absence of perfect foresight, reform will always necessarily be an iterative process.

There are, however, some general considerations that can be drawn from the Australian experience. In particular, the following observations can be made:

- adjustment costs may have been lower had prudential reform occurred at the same time as restrictions on competition were removed;
- reforms to the financial sector, in conjunction with the removal of controls on capital flows and exchange rates, can have significant effects on the conduct of fiscal and monetary policy. In Australia, these changes helped bring about pressure for an independent monetary policy and a medium term fiscal policy that reflected the impact of the budget on national saving; and
- reforms to one area of regulation have flow on effects to other areas of regulation. In Australia's case, financial sector reforms added to pressure for changes to other areas of regulation, such as competition policy, corporate law and taxation law.

4. Going forward

Australia has sought to develop a regulatory framework that is sufficiently flexible to remain robust in the face of future changes in the global environment. However, in recent decades the financial sector has been one of the most vibrant sectors in the Australian economy and this can reasonably be expected to continue over the foreseeable future. The structure and operation of the financial sector will continue to evolve as globalisation, financial convergence and the introduction of new technologies alters the business environment. This suggests that the regulation of the financial sector will continue to be a dynamic task.

The agenda for financial sector regulation in Australia can be split into two broad groups. First, a number of the recent financial regulation reform packages are currently being implemented and this process is likely to require, in some cases, up to several years. Secondly, there are likely to be several specific regulatory issues that will need to be assessed over the course of the next few years. Specifically, future challenges going forward include:

- continuing the implementation of reforms in the areas of financial services reform, general insurance (which are expected to be fully implemented by 1 July 2004), corporate governance, compliance with the recommendations of the Basel Committee on Banking Supervision (expected to be complete by 2007), and measures for improving the safety of superannuation;
- reviewing the regulation of conglomerates — the development of complex company structures, including intra-group transactions and cross-guarantees, has demonstrated that supervision would in some cases be more appropriately

conducted on a group basis. APRA has undertaken work to develop a framework for the prudential supervision of conglomerates that included an authorised deposit-taking institution;

- ongoing monitoring of the structure of financial regulation to ensure that it remains efficient and effective in the face of a changing global environment;
- considering the possible approaches to increase policyholder protection — the failure of HIH Insurance Group generated renewed discussion on the merits of establishing systematic arrangements to protect the interests of policyholders when an institution fails; and
- seeking greater international cooperation on financial sector regulatory issues. Regulation of financial services has been responding to the implications of globalisation through improved communication and coordination between financial regulators across different countries. The benefits of these closer relationships between regulators is likely to increase as the provision of financial services becomes increasingly internationalised.

Attachment: Chronology of major measures and reforms associated with the deregulation of Australia's financial sector

| Year | Measures/reforms |
|-------------|---|
| 1960 | Reserve Bank begins operations Sydney Futures market begins operations |
| 1962 | Three-month Treasury notes replace seasonal securities Savings banks allowed to make some personal loans |
| 1965 | Authorised money market dealers allowed to trade in commercial bills (previously only in government paper) Guidelines set to limit borrowing in Australia by overseas companies Trading banks offer unsecured personal loans |
| 1966 | Qualitative guidelines for bank lending (specifying categories of borrowers) cease |
| 1967 | Trading banks allowed to make secured personal loans, short-term mortgage loans and bridging loans Six-month Treasury notes issued |
| 1968 | Trading banks allowed to enter lease finance |
| 1969 | Trading banks allowed to issue certificates of deposit (CDs), but with constraints on rates and maturities |
| 1971 | Trading banks allowed to deal as principals in foreign exchange transactions with the Reserve Bank (previously banks acted as agents) Surveillance by Reserve Bank of capital inflows |
| 1972 | Embargo on foreign borrowings of less than two years. Constraints on overseas borrowings in Australia lifted. VDRs (variable deposit requirements) introduced requiring a non-interest bearing deposit equal to one quarter of foreign borrowing to be lodged with the Reserve Bank |
| 1973 | Controls on capital inflows further increased. VDRs increased to one-third Ceiling interest rate on CDs abolished |
| 1974 | Credit squeeze (later conceded to have been more severe than planned). CD rates rose above 20 per cent as the banks sought to improve their liquidity by liability management VDRs successively lowered and then dropped; and restrictions on foreign inflows relaxed Select Committee on Securities and Exchange report on the securities industry Financial Corporations Act became operative First Australian credit card (Bankcard) |
| 1976 | Australian Savings Bond (ASBs) replace Special Bonds. First issue heavily subscribed Monetary target introduced |

Chronology of major measures and reforms associated with the deregulation of Australia's financial sector (continued)

| Year | Measures/reforms |
|-------------|--|
| 1976 contd | \$A devalued; 'flexible peg' exchange rate system adopted. Australians permitted to trade in gold |
| 1977 | Restoration of restraints on capital inflows, VDR restored and set at one-quarter, later removed |
| 1978 | Further relaxation of constraints on foreign borrowing and investment |
| 1979 | Campbell Committee established Bank of Adelaide in difficulties because of property dealings of its subsidiary National Companies and Securities Commission established Interest rates futures traded and banks enter hedge market Treasury notes sold by tender |
| 1980 | Relaxation of controls on foreign portfolio investments Treasury bonds sales on tap instead of by periodic issues Banks permitted to have 60 per cent share in merchant banks (previously 30 per cent) Ceilings lifted on bank deposit rates but controls on maturities remain First cash management trust established |
| 1981 | Australian Bank established (first new bank licensed for more than half a century) Mergers of private banks reduce their number by two Maturity controls on CDs eased to allow issues of thirty days (down from three months) Final Report of Campbell Committee Savings banks introduce card accounts (previously passbook) |
| 1982 | Trading and savings banks given more freedom in liability management. End of quantitative controls on bank lending Savings banks' portfolio constraints eased Variable repayment home loans. Visa card introduced Tender system for Treasury bonds |
| 1983 | Announcement that new banks would be licensed Dollar floated Martin review group appointed by new government to assess Campbell Report Mastercard introduced |

Chronology of major measures and reforms associated with the deregulation of Australia's financial sector (continued)

| Year | Measures/reforms |
|-------------|---|
| 1984 | <p>Martin review group endorsed Campbell Report</p> <p>Stock exchanges deregulated</p> <p>NBFIs allowed to become licensed foreign exchange dealers. Controls on banks' deposit rates and maturities lifted</p> <p>Savings banks allowed to offer cheque accounts</p> <p>Interest paid on cheque accounts for first time this century</p> <p>Controls on foreign and domestic bank holdings of equity in merchant banks eased (later lifted)</p> <p>Applications for new banking licences invited in line with Campbell recommendations</p> |
| 1985 | <p>Monetary targets abolished</p> <p>Controls on bank lending rates lifted except for home mortgages. Reserve Bank commences process of developing prudential supervision</p> |
| 1985-88 | <p>Expansion of tax Base and tax reforms, including capital gains tax and fringe benefit tax, dividend imputation, superannuation, but not including a broad-based consumption tax</p> |
| 1986 | <p>Announcement that statutory reserve deposits (SRDs) are to be phased out</p> <p>Reserve asset ratio for savings banks reduced</p> <p>Home mortgage rates of banks deregulated except for existing loans</p> <p><i>Cheques and Payments Order Act 1986</i> allows non-bank financial institutions to issue payment orders</p> |
| 1987 | <p>Reserve asset ratio of savings banks reduced to 13 per cent</p> <p>Australian Stock Exchange commences operations</p> <p>Insurance and Superannuation Commission established</p> |
| 1988 | <p>End of SRDs. Prime asset ratio (PAR) reduced to 10 per cent. Savings banks subject to same PAR system</p> <p>Reserve Bank defines risk-weighted capital adequacy guidelines for banks</p> <p>Series of major collapses of financial enterprises and leveraged corporations</p> <p>Last issue of Australian Savings Bonds</p> <p>Government's tariff reduction program begins</p> <p><i>Commonwealth Industrial Relations Act 1988</i></p> |
| 1989 | <p>Amendments to Banking Act eliminates distinction between trading and savings banks and empowers Reserve Bank's prudential supervision</p> |

Chronology of major measures and reforms associated with the deregulation of Australia's financial sector (continued)

| Year | Measures/reforms |
|-----------|--|
| 1990 | <p>PAR reduced to 6 per cent</p> <p>New solvency requirements for general insurers announced. Restrictions on borrowings in Australia by foreign governments lifted. 12 month freeze on withdrawals from unlisted property trusts</p> <p>Australian Securities Commission replaces National Companies and Securities Commission, formation of Australian Financial Institutions Commission announced</p> <p>Martin Committee Report into Banking and Regulation</p> |
| 1991-2002 | <p>Privatisation of government business enterprises: Commonwealth Bank 1991; 1993; 1996: QANTAS 1992; 1995; Federal Airports 1997-98; Telstra 1997; 1999; National Rail Corporation and NSW Freightcorp 2002; Sydney Airport 2002</p> |
| 1991-92 | <p>Telecommunications monopoly ended, full competition not introduced into sector until 1997</p> |
| 1992 | <p>Amendments to prudential standards for insurance companies</p> <p>Reform of corporations law relating to directors' duties and disclosure</p> <p>Formation of council of Financial Supervisors to coordinate the activities of the major supervisory authorities; members comprise Reserve Bank (Chair), the Insurance and Superannuation Commission, the Australian Securities Commission, and the Australian Financial Institutions Commission.</p> <p><i>Industrial Relations Act 1988</i> amended to permit enterprise bargaining</p> |
| 1992-2002 | <p>Superannuation Guarantee Charge Introduced a system of universal minimum rate of employer superannuation contributions. The contribution rate increased from 3 per cent in 1992-93 to 9 per cent in 2002-03</p> |
| 1993 | <p>Federal legislation facilitates establishment of branches of foreign banks</p> <p>Superannuation Industry Supervision legislation increases prudential superannuation industry</p> <p><i>Industrial Relations Reform Act 1993</i> enacted, providing for both union and non-union agreements</p> |
| 1994 | <p>State and Federal governments establish a taskforce to promote a national prudential supervision for friendly societies.</p> <p>Reserve Bank announces that mortgage loans will attract the 50 per cent risk weighting — where the loan to valuation ratio is less than 80 per cent.</p> <p>New guidelines announced about the composition of bank boards and the role of bank subsidiaries as trustees for superannuation funds</p> |
| 1995 | <p>Sale of State Bank of NSW to the insurer, Colonial Mutual</p> <p><i>Life Insurance Act 1995</i> comes into force.</p> <p>National Competition Policy, implementation occurred in 1996 and is ongoing.</p> |

Chronology of major measures and reforms associated with the deregulation of Australia's financial sector (continued)

| Year | Measures/reforms |
|--------------|---|
| 1996 | Wallis Inquiry into Australian financial system begins Inflation target agreement with RBA |
| 1997 | Government announcement that tariffs on passenger motor vehicles (PMV) would fall until 2000, and would remain at that level until 2005 when there would be a further reduction to 10 per cent Similarly, tariffs on textiles, clothing and footwear (TCF) would continue to fall until 2000, remaining at their 2000 levels of 10, 15 and 25 per cent until 2005. From 2005, items at 25 per cent will fall to 17.5 per cent, those at 15 per cent to 10 per cent, and those at 10 per cent to 7.5 per cent. <i>Workplace Relations Act 1996</i> proclaimed, allowing formalised individual and collective (union and non-union) agreements Opening of telecommunications sector to full competition and the introduction of telecommunications-specific competition regulation National Gas Access Code Agreement |
| 1997 to date | Corporate Law Economic Reform Program (CLERP) including the <i>Financial Services Reform Act 2001</i> to improve Australian corporate governance standards and introduced a harmonised licensing, conduct and disclosure regime for providers of financial services |
| 1998 | <i>Charter of Budget Honesty Act 1998</i> . Creation of national electricity market Waterfront reform to improve performance |
| 1999 | The New Business Tax System reduces the company tax rate from 36 per cent to 30 per cent from 2001-02 and introduces an internationally competitive capital gains tax regime and a simplified tax system for small business |
| 2000 | The New Tax System introduces the goods and services tax (GST) |
| 2001 | Intergenerational Report opens community debate on medium-term demographic and fiscal issues |
| 2002 | Government announces that PMV tariffs would fall from 10 per cent to 5 per cent in 2010 The Productivity Commission is currently conducting an inquiry into post-2005 assistance arrangements for the TCF industry with a final report to Government due on 31 July 2003 |

Source: The Australian Government Treasury and 'The Australian Financial System: evolution, policy and practice', M K Lewis and R H Wallace.

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Key themes from the Treasury Business Liaison Program — November 2003

The following article is a summary of findings from the Treasury Business Liaison Program conducted in November 2003¹. Treasury greatly appreciates the commitment of time and effort made by the Australian businesses and industry associations that participate in this program².

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- 1 A detailed explanation of the Treasury Business Liaison Program is provided in the Treasury *Spring 2001 Economic Roundup*.
 - 2 Summary reports of Treasury's business liaison reflect the views and opinions of contacts. A summary of business conditions reported by liaison contacts is provided for the information of readers. While Treasury's evaluation of the economic outlook is informed by findings from business liaison, a much wider range of information and data is utilised to ensure a rigorous assessment of the Australian economy.

Overview

The November business liaison round comprised meetings with contacts in Sydney, Melbourne, Brisbane and the Riverina area, along with a number of phone interviews. Contacts were from a range of industry sectors.

Overall, contacts reported strong business conditions over recent months and were broadly optimistic about the outlook for their businesses and strength of the Australian economy more generally. Nonetheless, some contacts noted risks around the sustainability of the global recovery, the appreciation of the Australian dollar and ongoing effects of the drought.

The focus of most contacts was on continuing to reduce their cost structures and improve their efficiency in order to maintain a competitive edge and improve profitability.

Most contacts noted that their investment intentions remain solid but in some cases would be lower than recent high levels. Employment intentions for most contacts were broadly stable, while cost increases were generally considered manageable despite some contacts noting a slight increase in wage pressures.

General business conditions and outlook

The majority of contacts indicated that in general current conditions were good and that the outlook was positive. In particular, the construction sector was especially vibrant with many contacts surprised by the ongoing strength. Contacts in this sector were working close to capacity and did not expect a drop-off in work in the next 6-12 months. Communication sector contacts also indicated that the overall market continues to grow strongly.

The retail sector was expecting solid sales in the lead up to Christmas although as yet they had seen no signs of a 'break out' in spending. Expectations for spending next year were broadly in line with the strong growth experienced this year. A number of contacts in the entertainment sector indicated that their turnover was largely independent of the overall level of economic growth but influenced more by longer-term trends, such as demographics and regulatory change.

A number of contacts indicated that they were facing challenges. However, these challenges typically related to industry specific issues — such as industry consolidation, changes in technology and increased competition.

- For example, the photographic industry faces challenges from the more widespread use of digital technology.

Some export contacts suggested that they had benefited from increased global demand — especially from China — for their products. A number of contacts also indicated that they faced mature markets in Australia and that opportunities for expanding their business increasingly lay overseas. In particular, the importance of the Asian and United States markets was highlighted by several contacts.

- For example, transport sector growth in Asia was reported to be around 3 times as high as in Australia.

According to most contacts, the Reserve Bank of Australia's recent decision to increase interest rates has had a negligible impact on business activity to date. However, a number of contacts raised concerns about the impact of future increases on the spending of their customers. Exporters were also concerned about the implications of future interest rate rises for the exchange rate.

The key risks identified by contacts included the sustainability of the global recovery, the appreciation of the Australian dollar and the ongoing effects of the drought.

Rural economy

A number of contacts indicated that the rural economy continues to be held back by the lingering effects of the drought. Some regions continue to be affected by poor rain as well as the impact of strong winds and late frosts.

In addition, efforts to replace livestock lost during the drought is taking place against a backdrop of high cattle and sheep prices. A number of contacts indicated that gaining a return on these investments remains highly dependent on getting further rain this year.

Some contacts also noted that the loss of production last year due to the drought had been offset to some extent by higher rural commodity prices. However, this year some prices had fallen, which, combined with continuing low levels of production in some areas, would have a significant impact on some farm incomes.

Contacts in the Murrumbidgee Irrigation Area indicated that although the irrigation water has insulated them from the full effects of the drought, ongoing low rates of general access to water — and dramatic increases in the cost of water — were likely to restrict output of some crops this year. Contacts also indicated that the country surrounding this area remained 'fragile' and had not really recovered from the drought.

Aside from drought, the key risk to farm income identified by rural contacts was the exchange rate. This issue is discussed further below.

Competition and costs

A common theme raised by contacts was the increasingly competitive nature of their markets. A number of contacts noted that competition was both domestic and international in origin. In some industries there was also excess capacity which was driving down prices.

Consistent with these competitive pressures, the majority of contacts were currently focusing on containing or reducing costs. A common theme was a reorganisation of supply chain or inventory management practices.

Most contacts suggested that cost pressures were broadly manageable, although some suggested that there was a slight increase in wage pressures. This was most noticeable for those recently signing enterprise agreements covering multiple years, where recent wages increases were higher than those agreed 2-3 years earlier. Some contacts also indicated that it was becoming harder to find productivity offsets when negotiating enterprise agreements.

Some contacts suggested that their regulatory costs were increasing. From a reporting and disclosure perspective they typically saw this as a reaction to recent high profile bankruptcies. These costs were especially high for those companies who also report back to the United States, where recent changes to accounting standards have 'raised the bar considerably'.

Some contacts indicated that increases in freight costs were affecting profitability. Several contacts also noted an increase in security costs both in Australia and overseas — including to meet new regulatory standards in the United States. This was most evident in the transport sector.

Insurance costs generally appear to have stabilised following rapid growth in recent years. However, several contacts raised workers compensation costs as an issue and indicated a preference to self insure as the setting of premiums on an industry wide basis did not accurately reflect their individual level of risk.

Australian dollar

Contacts views on the effects of the appreciation of the Australian dollar were mixed. Those contacts most concerned were typically manufacturing, mining and rural exporters who indicated that the previously low level of the Australian dollar had provided Australia with a competitive edge over international competitors, but that the recent appreciation had eroded this advantage. As a result, countries such as China and Sri Lanka were now more able to take advantage of their low labour costs to compete effectively in a number of markets.

- Some contacts suggested that the current level of the dollar is already putting pressure on sales while other contacts indicated that the present level is manageable but that further increases would cause problems.

Offsetting this, importers were expecting to gain from the appreciation of the Australian dollar with suggestions that some businesses were taking advantage of the opportunity to import low cost capital. However, other contacts noted that there was yet to be a flow-through to the prices of certain imported machinery and that such a flow-through typically took some time to eventuate.

A considerable number of contacts indicated that they had a high level of cover against movements in the exchange rate. In a number of cases this reflected the use of natural hedges — for example, many contacts are both importers and exporters while other companies had established operations overseas or negotiated contracts in Australian dollars. Other contacts had purchased cover through the use of derivative products. Some contacts noted, however, that this cover is beginning to run out and that the value of the Australian dollar is beginning to impact on negotiations of new overseas contracts.

Employment and investment

Most contacts indicated that they intended to maintain broadly stable levels of employment over the next year. Several contacts also indicated plans to manage the amount of staff turnover. There were few reports of skill shortages or difficulties in attracting qualified labour.

Investment intentions were generally solid and broadly consistent with longer-term trends. In a number of cases this will mean a reduction from high levels achieved last year following significant expansions and capital upgrades. Several contacts were yet to finalise their investment plans.

Sources of economic data

The following table provides sources for key economic data. ABS data can be obtained over the internet at <http://www.abs.gov.au>. The Reserve Bank of Australia information is available at <http://www.rba.gov.au>. Similarly, OECD information is available at <http://www.oecd.org>. Information on individual economies is also available via the IMF at <http://www.imf.org>.

International economy

| | |
|--|-------------------------------|
| Output, current account balance and interest rates | OECD Main Economic Indicators |
| Consumer price inflation | ABS Cat. No. 6401.0 |

National accounts

| | |
|---|---------------------|
| Components of GDP, contributions to change in GDP | ABS Cat. No. 5206.0 |
|---|---------------------|

Incomes, costs and prices

| | |
|--|---|
| Real household income | ABS Cat. Nos. 5204.0 and 5206.0 |
| Wages, labour costs and company income | ABS Cat. Nos. 5204.0, 5206.0 and 6302.0 |
| Prices | ABS Cat. Nos. 6401.0 and 5206.0 |
| Labour market | ABS Cat. No. 6202.0 |

External sector

| | |
|--|---|
| Australia's current account, external liabilities and income flows | ABS Cat. Nos. 5368.0, 5302.0 and 5206.0 |
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Past editions of Economic Roundup

Details of articles published in the past two editions of the Economic Roundup are listed below:

Spring 2003

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Key themes from the Treasury Business Liaison Program — July / August 2003

Treasury submission to the Senate Economics References Committee Inquiry into the Structure and Distributive Effects of the Australian Taxation System

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Copies of these articles are available from the Treasury. Written requests should be sent to Mr David Hedley Department of the Treasury, Langton Crescent, Parkes, ACT, 2600. Telephone requests should be directed to Ms Susan O'Shea on (02) 6263 3797.

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