Mr Macfarlane: Opening address to the Euromoney Australasian Capital Markets Forum

Opening address by Mr I J Macfarlane, Governor of the Reserve Bank of Australia, to the Euromoney Australasian Capital Markets Forum, held in Sydney on 14 March 2000.

*   *   *

I would like to start by thanking Mr Brady for his introductory remarks, and to say that, in our view, Euromoney made a very sensible choice in scheduling a Capital Markets Forum in Sydney. It recognises the significance and growth potential of our capital markets, and the generally improved prospects for this region. I see a very impressive list of speakers and participants before me and I am sure there will be a lot of fruitful discussion over the next two days.

The timing of the Conference is interesting in that it comes at a time when we can safely say that the Asian crisis is behind us and that, with a couple of exceptions, the outlook for this region is good. Perhaps it was Australia's success in withstanding the contractionary effects of this crisis that encouraged Euromoney to hold its Conference here at this time. Whether that is the case or not, I would like to take the Asian crisis and its spillover to other emerging markets as the starting point for my comments this morning.

I do not wish to go over the macro-economic issues because I have already done this before. I would instead like to ask what did we learn from this crisis that was of immediate relevance to capital markets? What are the implications for developed economies such as Australia?

My answer to the first question is that we learnt that, for a country to play in the international financial market place, it needs a very sound financial infrastructure. I do not wish to suggest that it was the lack of this which caused the Asian crisis (the cause lay elsewhere), but it was this deficiency which made the crisis so deep when it occurred.

By financial infrastructure, I mean:

- the body of commercial law which covers everything from the concept of limited liability to bankruptcy provisions;
- the conditions under which entities can issue debt and equity;
- the body of competition law, trade practices law and securities regulation which ensures arm's length dealing and limits related party transactions;
- the supervision of the banking system, including regulation of near banks such as finance companies and merchant banks;
- the provision of a safe payments system;
- the application of sound accounting standards;
- the existence of a court system which is capable of timely resolution of disputes and which has the confidence of local and foreign participants.

This is quite a demanding list for several reasons. First, it is quite broad and involves the legal system, the Government, regulatory bodies, financial market participants and the professions. Secondly, and more importantly in my view, the achievement of a high standard in each of the items on this list takes a very long time. In our case, some of these things took a century to achieve. In many cases, we look back to periods as recent as the 1980s and wonder why we ever thought that we had done enough.

That is one of the reasons I have been sympathetic to our Asian neighbours. It is inevitable that at an early stage of development of a country, its financial infrastructure will be only partly formed.

Furthermore, even with the best will in the world, it is going to take time to bring these things up to scratch.

When people say that the recent financial and economic instability was the inevitable result of a combination of the free flow of international capital plus inadequate financial infrastructure, there is much truth in the statement. But if that is the case, we cannot expect a sudden return to stability because the second essential component - the adequate financial infrastructure - will take years, or possibly decades - to achieve.

The second thing we learnt from the Asian crisis, and its spread to other countries, was the necessity of having deep and liquid financial markets. We also learnt it was an advantage to have a floating exchange rate, and to have a capital market that was diversified and not one that was too dependent on the commercial banking sector.

This brings me to the Australian financial system, to the capital markets and to financial markets more generally. The Australian financial system has developed rapidly over the past 20 years or so, with deregulation being a major driver of change. Deregulation started in the late 1970s with the gradual removal of controls over bank interest rates. It picked up speed in the early 1980s with the removal of other controls on banks, freeing up interest rates on government securities (by adopting tender arrangements for new issues), floating the exchange rate and opening up the banking system, in the mid 1980s, to foreign competition. Shortly thereafter, bank supervision was formalised, and the Basel framework for capital adequacy of banks was adopted in 1988.

The development of the financial markets in Australia is not, of course, the result purely of regulatory change. Financial institutions themselves have taken the opportunity to develop new markets and introduce new products. For example, in 1979 the Sydney Futures Exchange was the first derivatives market outside of the United States to introduce a contract based on a financial instrument when it introduced the futures contract on 90-day bills.

Australian financial markets have become larger and more diverse over time and are now regarded as both sophisticated and deep. Turnover in the major Australian markets - the foreign exchange, money, equity and derivatives markets - has grown at average rates of more than 20% a year since deregulation. The exception to this rule is the market for government securities, which has grown more slowly than other markets in recent years because of the Government's run of budget surpluses. The relatively even pattern of development in Australia reflects both a lack of regulatory distortions or incentives, and the fact that, unlike the entrepot markets in Singapore and Hong Kong, Australian financial markets have a reasonably large domestic economy to serve.

As in most countries, the foreign exchange market has the largest turnover, with about $75 billion a day, a little over half of which involves the Australian dollar. The Australian foreign exchange market is the ninth largest in the world and the Australian dollar is the seventh most actively traded, marginally behind the Canadian dollar. To put this in perspective, Australia ranks as the 14th largest economy in the world, so the Australian dollar trades more actively than might be expected given the size of the economy. Its relatively high position globally reflects the place the Australian dollar holds in portfolios of international funds managers because of the opportunities for diversification it affords.

The standing of the Australian dollar as a world currency is recognised by its inclusion in the first wave of seven currencies in the CLS System or Continuous Linked Settlement System for foreign exchange settlement which is scheduled to come into operation in 2001. The other currencies are the US dollar, euro, yen, Swiss franc, pound and Canadian dollar. Australia's position in world financial markets was reinforced recently when it was one of four "significant financial centres" invited to join the G7 countries in the Financial Stability Forum, an inter-governmental group which monitors risks in the international financial system. As a "systemically significant economy", Australia is also a member of the G20, which has been charged with broadening the dialogue on key economic and financial policy issues globally.

A major gap in the development of Australian markets until recently was the domestic non-government bond market. This market, however, has recently grown strongly, representing further welcome diversification for borrowers and lenders. With non-government bonds on issue now totalling about $66 billion, this market is now about as large as the market for Commonwealth Government securities. This development is beginning to produce a "credit curve" in Australia. Now that bond yields in Australia have moved lower on the back of low inflation in recent years, the incremental pick-up for taking credit risk probably looks more attractive to investors than it might have a decade ago when bond yields were perennially double-digit numbers.

The financial infrastructure in Australia has evolved to accommodate this growth of financial activity. Practitioners and the authorities have worked together to ensure that the "plumbing" kept pace with the system it was serving. In the case of payments and settlements systems, Austraclear and the Reserve Bank's RITS system, which introduced delivery-versus-payment, and then the ASX's CHESS system for equities were important steps forward. Our systems meet the highest international standards, as specified by the Group of 30. They have been inter-linked through the RTGS system to provide a very efficient payments and settlements infrastructure. Australia's RTGS system is among the most advanced in the world because of the way it closely links to securities settlements, giving it a very high coverage of high-value transactions.

We have already witnessed a major reorganisation of our financial regulatory agencies with the formation of APRA and changing responsibilities for the RBA and ASIC. The reform process is, of course, ongoing. The main item on the agenda at present is the so-called CLERP initiative - Corporate Law Economic Reform Program - which aims to achieve best practice in fields such as accounting standards, disclosure, corporate governance, and takeover law. It also aims to facilitate the application of technology to the conduct of business and promote competition in financial markets, including in investment products.

The expansion of financial activity in Australia has not been confined to market trading. Holdings of financial assets in general have expanded rapidly. In the early 1980s, holdings of financial assets were about the same size as GDP; these days, they are about 2 1/2 times the size of the economy.

The development of financial markets and the financial system has not benefited only the "big end of town" - if anything, the system has become more "democratic". One measure of this is the spread of ownership of equity, with share ownership by individuals increasing sharply in Australia in the 1990s. The Australian Stock Exchange estimates that 54% of adult Australians now hold shares directly (including through personally managed superannuation funds); in 1991, this figure was 22%. This trend reflects the programs of privatisation and demutualisation in Australia in the 1990s. Another measure of the "democratising" of the financial system is that practically all permanent employees now receive privately funded superannuation benefits, compared with less than half a decade ago. It is the investment of these funds which has provided such an important stimulus to the growth of the funds management industry over the past decade and a half.

It is growth in the size and diversity of financial markets that makes life rewarding and profitable for market participants like yourselves. But from my perspective, the size, and particularly the diversity, of financial markets are also important. Representing an institution that is responsible not only for monetary policy, but also for financial stability more generally, I am conscious of the value of a strong and diverse set of financial markets and institutions.

To illustrate this point, I want to conclude with a few words from Alan Greenspan. In a speech last September on Lessons from the Global Crisis, he went over the experience of a number of countries and attempted to draw some conclusions, which are of relevance to what I have been discussing. In his view (and I will quote):

"The mere existence of a diversified financial system may well insulate all aspects of a financial system from breakdown. Australia serves as an interesting test case in the most recent Asian financial turmoil. Despite its close trade and financial ties to Asia, the Australian economy exhibited few signs of contagion from contiguous economies, arguably because Australia already had well-developed capital markets as well as a sturdy banking system. But going further, it is plausible that dividends of financial diversity extend to more normal times as well."

On that note, I will conclude and wish you all well for a fruitful and stimulating Conference.