

Ric Battellino: The strength of the Australian economy and financial markets

Remarks by Mr Ric Battellino, Deputy Governor of the Reserve Bank of Australia, at the Launch of the 2007 Australian Financial Markets Report and the Invest Australia Gold Book, Sydney, 19 September 2007.

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It's a pleasure to take part in the launch of these two reports that highlight the strength of the Australian economy and financial markets.

I would like to congratulate Invest Australia, the ASX and AFMA for putting together such comprehensive and informative documents. They are of immense benefit not only to market participants and foreign firms looking to enter the Australian market, but also to regulators, academics and students.

I would also like to congratulate the three organisations more generally for the excellent job they do in supporting, promoting and helping to regulate Australian financial markets. This is important work because finance makes such a vital contribution to the Australian economy, not only directly, but also through its role in supporting other sectors of the economy.

As noted in the *Invest Australia* report, Australia has had an extended period of strong economic growth, which is about to head into its seventeenth year. Even if we take just the past decade, real GDP has grown by a cumulative 40 per cent and nominal GDP has grown by 90 per cent.

Financial markets have exhibited even faster growth over this period. The value of companies listed on the ASX has grown by 275 per cent, and the value of debt securities on issue in Australia has increased by 170 per cent.

The growth of turnover in financial markets has been even more dramatic, increasing by 290 per cent over the decade. So while the nominal economy has almost doubled in size over the past ten years, turnover in financial markets has almost quadrupled.

The remarkable thing is that the pace of growth shows no sign of slowing.

The members of the Campbell Inquiry, who helped set Australia on the path of financial deregulation and market development, would I think be very pleased at the way the financial system has evolved over the ensuing 25 years or so.

The previous speakers have outlined the highlights of the reports being launched today, so I won't repeat them. Rather, what I would like to do is take a step back from the impressive figures contained in those reports, and consider two questions:

- why do financial markets and market turnover consistently grow faster than the economy as whole? and
- what does all this increase in financial activity mean for the real economy?

Turnover and GDP

Let me start with the first question.

Financial markets play an important role in mobilising savings and allocating them to the most productive investment opportunities. There are therefore strong links from financial markets to the economy. The Australian economy would not have been able to record the strong growth that it has if there had not been such a strong expansion in financial markets. Of course, the links between markets and the economy also run strongly in the other

direction: without strong economic growth, we would not have seen financial markets develop as they have.

Even acknowledging these strong two-way links, however, we are still left with the question of why financial activity consistently rises faster than economic activity.

Part of the answer is that the rapid growth in financial activity is due to rising private sector wealth, as this also has been rising faster than GDP. Over the past decade, for example, household financial wealth has risen by about 170 per cent, compared with the 90 per cent increase in nominal GDP noted earlier. A lot of this increase in wealth has found its way into the superannuation industry, where it is professionally managed across a wide range of markets, and this no doubt has contributed to financial market activity.

But even this rapid growth in wealth still falls short of growth in financial activity. So I don't think this is the complete answer.

The other part of the answer, I think, is innovation.

Innovation has been a key feature of financial markets throughout the past 25 years. This has increased the range of financial products available to savers and investors, providing them with more opportunities to adjust their assets and liabilities to fit in with their risk/return preferences. Often this has been done by breaking down financial products into their component parts. A good example is the way in which derivative products have allowed the various risks that are inherent in financial products to be separated, so that investors need only take on those risks with which they are comfortable.

One only has to look at how the variety of financial products has expanded over the years, and the broad range of markets that are now listed in the AFMA report, to get a feel for how innovative and dynamic the finance industry has been.

This innovation has encouraged market turnover in several ways:

- First, there is the new product effect. Like all new products, new financial products typically experience very rapid growth in their early years, as users discover their advantages.
- Second, innovation has provided savers and investors with more variety, giving them greater scope to adjust their portfolios.
- And lastly, and perhaps more importantly, innovation has reduced costs, so the barriers to saving and investment, and to changing portfolio structures, have diminished.

What does the increase in financial activity mean?

Let me now move to the second question.

Financial market activity is, of course, not an end in itself – at least for those people not employed in the finance sector – so the important question most people want to know is what this increase in financial activity means for the real economy.

Here, I think, the answer is a very positive one.

Vibrant, competitive and innovative financial markets work to increase the availability, and reduce the cost, of finance.

There are some obvious examples of how this affects our day-to-day lives.

Take the housing market. The development of wholesale capital markets provided funding for non-bank lenders and allowed them to compete with deposit-taking institutions in housing lending. This led to a substantial reduction in interest margins on housing lending, from about

400 basis points 15 years ago to a little over 100 basis points today. This has been a very material benefit to Australian households.

The benefits of financial market development have not been restricted to households. Interest margins and the cost of borrowing have also come down for businesses, as financial intermediaries have competed with capital markets in meeting businesses' funding needs. Fifteen years ago, the average interest margin on business loans was 570 basis points; today it is only 135 points.

In short, the trading and innovation that we see in financial markets eventually flows through to reduced costs for the users of financial services. This has meant that the amount spent by households and businesses on financial services has grown much less than financial activity. For example, even though financial activity has risen by a factor of several times GDP over the past decade, the finance and insurance sector's share of national income has risen only slightly, from around 5½ per cent to around 7 per cent.

Financial innovation has also allowed households and businesses to reduce risks. Firms have been better able to structure their financing to suit the characteristics of their businesses and to manage the risks associated with their revenue flows. Foreign exchange and commodity derivatives are good examples of innovations that have helped many Australian companies in this regard.

The overall effect of all this has been to make the economy more resilient and stable. The ability of the Australian economy to come through the Asian financial crisis largely unscathed owed importantly to the fact that Australian firms and financial institutions had been able to hedge a lot of the risks that caused so much damage elsewhere in Asia.

The diversity and depth of Australian markets, by ensuring that avenues of financing are always available, also add to the resilience of the economy.

I would also give some credit to the financial sector for contributing to the reduction in inflation volatility we have seen over the past 15 years. Part of this can be traced to the reduced pass-through to inflation of changes in the exchange rate, which, in turn, has been partly attributable to the increased use of exchange rate hedging by firms.

Conclusion

So let me end by saying that it is clear that the growth of financial markets and the growth of the economy are closely intertwined. Financial markets need a strong economy to thrive, and the economy needs strong, vibrant and well-regulated markets if it is to continue to expand.

I think that it is fair to conclude that Australia to date has been well served by its financial markets, and I would encourage you to continue to work to maintain these high standards.