AUSTRALIAN STOCK EXCHANGE
LIMITED ACN 008 624 691 ("ASX")

# SUBMISSION

# Standing Committee on Economics, Finance and Public Administration

## Inquiry into the international financial market effects on government policy

**May 1999**

**Introductory comments**

ASX believes that the Australian government should focus on the benefits of international capital mobility, while taking action to minimise the costs of recurrent crises through appropriate and well-funded international central banking institutions and practices. While the effect of international capital mobility on national welfare is complex and uncertain, **there is a common theme from economic analyses of international financial structures: the ability to attract international capital to boost development or cushion the costs of macroeconomic policy mistakes is very valuable.**

If there were no reasonable prospect of successfully managing international financial crises, then the associated risks of depression would probably outweigh the benefits of capital mobility. International financial crises turned the global recession of 1929-1931 into the Great Depression, generating a decade of relative poverty. The Latin American debt crisis of 1982 significantly diminished economic growth in several countries for a decade or so. These periods demonstrate the risks associated with flows of international finance.

The benefits of foreign capital for economic welfare must also be emphasised. The flow of finance from the British core to the periphery in the late nineteenth century played an important role in producing the Australian and North American economies that have had among the world's highest standard of living in the twentieth century. Similarly, the flow of finance from today's industrial core to the newly industrialised countries has facilitated their growth in productivity and economic welfare. In all of these 'peripheral' countries, investments in modern machine technologies, financed by foreign capital, have proven to be an efficient way to upgrade the skills of the labor force and gain the organisational expertise necessary for high productivity.

**ASX believes that while financial crises will occur, the developing international finance regulatory structure is gradually adapting to successfully manage international financial crises.** For example, the Mexican crisis of 1994-95 was successfully handled, and Mexican economic growth resumed after a single year of recession. The East Asian crisis of 1997 led to declines in growth in 1998, but the performance of some countries such as South Korea have already turned around in 1999.

**ASX believes that regulatory management of capital flows role is the appropriate role for government, rather than making policy judgements about the preferable magnitude or volatility of these flows. In fact, it appears that financial crises typically arise due to government attempts to influence capital flows for short-term economic policy objectives.** For example, fixed exchange rates and investment guarantees were used in several Asian countries to maintain GDP growth at unsustainable rates during the 1990s. In contrast, governments in Australia and the US have put their efforts into enhancing market processes, by reducing government intervention and increasing market participant information. Reforms under consideration in the US, as discussed in this submission, reflect a strengthened commitment to these goals. In most OECD countries, direct financial intervention is limited to monetary policy for the pursuit of long-term economic goals. In Europe, even this form of

policy is being diminished as a national policy tool, through monetary union and the European Central Bank.

**In Australia, ASX believes that the government policy should focus on the long-term regulatory structure required for the financial services sector of the economy.** This is a complicated task in Australia, as the development of international financial markets is ongoing following reforms during the 1980s such as the floating of the exchange rate and the deregulation of the banking sector. There are a wide range of possibilities for integrating Australia into global market, and we should give considerable weight to the emerging international structures that we will need to accommodate in the future.

## Recommendations

ASX asks the Committee to note that speculation in financial markets simply facilitates the communication of new information by market participants. The speed and magnitude of asset allocation decisions is increasing rapidly, which places much greater pressure on national governments to implement policies based on sound economic principles. No crisis arises from the vast majority of financial transactions, which suggests that governments in most countries make well-founded policy decisions. **ASX recommends that the focus of government be on the policy motivations for financial market transactions, rather than their magnitude.**

The Australian government has important economic policy instruments at its disposal. The use of these tools is at world-class standards, as reflected in our economic performance during the Asian financial crisis in the past two years. These policies, such as a floating exchange rate with scope for occasional currency intervention and official interest rates in money markets, are founded on our national currency. Given the importance of these policy tools, **ASX suggests that is vital that we maintain the Australian dollar rather than become part of a monetary union with one or more other nations.**

The regulatory structure for financial markets must be under constant evaluation, so as to accommodate the innovative responses of market participants to consumer demands while ensuring adherence to prudential standards. Recent analysis of financial market regulation in the US suggests that improvement of reporting requirements, rather than a wider regulatory net, is the preferred response to the problems evident in some US institutions. **ASX recommends that detailed analysis of the reporting requirements of relevant financial institutions be undertaken before similar recommendations are made in Australia. It should be established that more detailed and frequent reporting creates a significantly better informed marketplace. Furthermore, ASX recommends that further analysis of the value of reporting obligations for public companies must be undertaken before an appropriate position on such requirements can be developed.**

*The implications of the globalisation of international financial markets for the conduct of fiscal and monetary policies in Australia, including medium-term and other strategies to cope with potential volatility in markets.*

The vulnerability of any economy, especially a small country caught in the commodity and financial markets of a big world, is insufficiently appreciated. These forces make it vital that analysis of fiscal and monetary policy takes in a range of possible scenarios, including the potential for shocks that might force the economy away from its long-run path for periods of time.

It is clearly desirable to preserve some possibilities of autonomy in national and continental monetary policies and to defend them against the growing internationalisation of money markets.

The current set of Australian policy choices reflect these goals. A flexible exchange rate was introduced in 1983 to facilitate the transmission of Australia's international competitiveness into trade and financial decisions. Competition in the banking sector has been allowed to increase the level of competition in financial services.

We have maintained important policy tools to manage shocks to our economy. Monetary policy is exercised to manage inflationary pressures, and fiscal policy enables the government to increase expenditure if a recession occurs overseas and is 'imported' to Australia.

A floating exchange rate enables our economy to respond to broad changes in our competitiveness against a trading partner. It is important to note that such changes can occur due to structural changes in relative prices, as well as short-lived forces.

The best set of policies does not make our economy or policy makers immune from trends in international financial markets. Trading of currencies for speculation rather than trade or investment is perhaps the most obvious manifestation of globalised markets. The worldwide gross volume of foreign exchange transactions is mind-boggling, at $A 1.3 trillion per business day and growing [1]. Nine-tenths of these transactions are reversed within a week, mostly within a day. Clearly many of these trades are speculative.

The gross volume of foreign exchange trading dwarfs the net capital transfers that carry the economic benefits that globalisation is advertised to bring. The RBA Deputy Governor has made this point: 'while the general case in favour of capital flows is a powerful one, the practical problem is their variability - the surges and reversals' [2].

In addressing this market, two questions arise:

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[1] 'Financial Globalisation' Paper by Professor James Tobin to the American Philosophical Society Symposium on the Globalisation of the World Economy, February 19, 1999.

[2] 'Capital Flows and Crises', Address by Dr S.A.Grenville,Deputy Governor of the Reserve Bank of Australia to the Credit Suisse First Boston Australia Conference, 'The Global Financial System –The Risks of Closure', Sydney, 13 November 1998.

- Does speculation on currencies or volatile capital flows reduce national economic welfare ?
- If so, then how might volatility be reduced ?

The answer to the first question requires greater exploration of the motivations for speculation. Some aspects of financial globalisation are perilous to the health of central banks and economies. This is especially clear in fixed exchange rate or adjustable peg regimes. The extensive liberalisation of Asian capital markets was consistent with the policy goal of providing a large supply of low-cost funds to national financial institutions and domestic corporate sector. Unfortunately, the same goal motivated exchange rate policies aimed at reducing the volatility of the domestic currency in terms of the US dollar, thus lowering the risk premium on dollar-denominated debt.

In the context of the Asian crisis, speculation about the survival of pegged exchange rates eventually precipitated the capital outflow from the region, which merely increased the pressure on relevant exchange rates. The focus here should be on the fixed exchange rate policies operated by several Asian countries, which were a root cause (but not the only one) of financial collapse. Expectations of the eventual break of a pegged rate had built up, which provided a fertile ground for speculative investment.

This example suggests that a distinction can be made between the speculation and volatility of capital flow attracted by bad economic policy, and that which occurs under sound policy. Even with appropriate economic policies (setting aside the definition of such policies), critical levels of speculation can occur. The RBA Deputy Governor argues this point: 'So even if policy-makers (working as they do in imperfect, politically driven worlds) were able to produce consistently good policies (a big ask), this is no assurance against volatility in capital flow' [3].

This view of international finance reveals some of the meaning embedded within the term speculation. For an investment decision, there can be both risk (where the probability of an outcome is estimable) and uncertainty (where the probability of an outcome is not estimable). Changes in risk assessments are based on new information that alter the probability of outcomes. Uncertainty is inherently a more qualitative component.

Speculation is based on risk assessments, so it is fundamentally affected by the quality, accessibility and frequency of new information. International financial markets take this information, and determine its significance in a myriad of ways, assessing direct and indirect effects on financial instruments and economies. Analysis and action based on information, including speculation, can greatly enhance economic welfare by adjusting relative prices.

For example, floating currency rates and concomitant speculation can be credited for accompanying economically desirable revaluations without

[3] 'Capital Flows and Crises', Address by Dr S.A.Grenville, Deputy Governor to the Credit Suisse First Boston Australia Conference,'The Global Financial System –The Risks of Closure', Sydney, 13 November 1998.

currency crises. A recent example is the 40 per cent decline of the yen against the US dollar between June 1996 and June 1998, which was not described as a global problem. It appears that it is the time taken for change to occur, rather than the size of the change, that distinguishes a crisis from a movement to a new equilibrium position. Australia endured significant fluctuation in our exchange rate against key trading partners during 1998. The path of currency value was undoubtedly affected by speculation about the short-term and long-term impacts of the Asian crisis on our economy. With rapidly changing information, expectations formation was under constant pressure, and there was some degree of overshooting in the depreciation of the Australian dollar [4]. In this case, the market function was adequate and the RBA did not change official interest rates.

While international financial markets are more stable for large trading economies, it could be argued that the multiplicity of financial instruments is an unnecessary source of financial activity. In this argument, it is the number of instruments, rather than trading per se, that is the problem. The more financial instruments like currencies become globalised, the larger the set of interactions between them, which serves to stimulate speculation. If a smaller set of financial instruments could develop, then the cost of financial markets is reduced, and there are fewer relationships to speculate about.

Hence, a way to escape currency crises is to adopt permanently and exclusively a common international currency, as has occurred occur within most of the European Union. Similarly, Australia could let a major foreign currency, such as the US dollar, become our means of payment and unit of account. This proposition is being actively debated in a number of countries where 'dollarization' is under consideration. Alternatively, if a unified Asian currency develops, then Australia could be part of such a monetary union. For example, the Association of South-East Asian Nations (ASEAN) is undertaking a detailed study of this issue [5].

There are some very important government policy objectives, however, that require a separate national currency. Firstly, dollarization could mean that Australia would lose its capacity to undertake monetary policy. Dollarization deprives the government of the small country not only of monetary sovereignty but also of seigniorage [6].

Secondly, even if Australia was content with the monetary policy of the other country, separate currencies are useful means of transmitting price changes that are geographically isolated. Sometimes changing market conditions force broad changes in the ratios of national price levels. For example, prices and wages in Australia may need to broadly change compared to those in the US. A country whose wages and prices are too high compared with those abroad will find it much easier to make the necessary adjustment

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[4] 'Opening Statement to House of Representatives Standing Committee on Economics, Finance and Public Administration' by Mr. I.J McFarlane, Reserve Bank of Australia Governor, 15 December 1998.
[5] 'ASEAN Considers Single Asian Currency Unit', The Age, 20 April 1999.
[6] Seigniorage is the difference between the face value of currency and its production costs. Government revenue from seigniorage is generated when the public exchanges interest-bearing assets for coins or paper currency.

via a change in the value of its currency than through thousands of changes in individual prices. But if two countries are subject to strong "asymmetric shocks" - then one would sometimes be in a boom while the other was in a slump and vice versa, then there is a good case for their having separate currencies whose relative values are allowed to fluctuate.

Australia’s geographic isolation results in a fairly low proportion of trading in factors of production and outputs. This means that we are more likely to be subject to asymmetric shocks, and should place great value in having a national currency.

*Information requirements for the stable and efficient operation of international financial markets, including the provision of information by governments and disclosure by market participants, especially by large market participants including highly leveraged institutions.*

*The relevance to these issues of recent developments in the international framework for financial regulation.'*

The government should take a long-term perspective when considering the effective management of financial markets. As discussed above, information is critical to the function of international financial markets. As a result, market participants have a vested interest in privately pursuing information.

It can be the case that some forms of information have public good characteristics - when information can be used by one market participant without diminishing its value. Government regulation to require the publication of information may be used to make information public.

The government also regulates financial markets by placing prudential controls on financial institutions. For example, the government may place limitations on balance sheets of intermediaries in cases where the state has implicitly or explicitly has a responsibility to compensate losers.

At issue in the current debate is the fact that some US financial institutions have operated outside of the prevailing regulatory structures. Some pooled investment funds are structured so they don't have to limit their investments within the parameters for mutual funds outlined in the US Investment Companies Act of 1940. For that reason, most hedge funds don't currently have reporting requirements, and many are headquartered offshore in exotic locations such as the Cayman Islands.

The fact that these funds operate outside legislation governing most mutual funds influences the type of investor that is attracted to them. Hedge funds are for people with a lot of money to invest. US hedge funds have average investments of about US$300,000. The funds can ‘short’ stock, which means they can gamble that prices will fall. They can buy ‘distressed’ securities or use options, derivatives and other complicated instruments. However, these techniques are not necessarily performed to increase risk - rather, the purpose of some funds is to reduce risk by taking a set of positions that serve to pass on the risk to another party.

In the US, hedge funds account for a small proportion of total financial assets. There are about 4,000 hedge funds with assets of roughly $400 billion, according to some industry estimates, compared to mutual funds that have assets of about $5,000 billion. As a result, it not surprising that several studies found that hedge funds did seem to precipitate financial market crises in Asia and other developing countries.

On the other hand, the liabilities of such funds are potentially much more significant, due to the leverage that such funds can exercise through repurchase agreements and derivative contracts. The fact that they are not regulated in a comparable fashion to other mutual funds has attracted much attention in the United States, due to the insolvency of prominent hedge funds following the Asian crisis.

Exchanges have margining arrangements, which are important safeguards that limit the accumulation of liabilities by market participants. When market participants take a position, they must lodge a deposit or initial margin with their broker. The deposit is held with the exchange clearing house. A derivatives contract is revalued, at market prices, on a daily basis. Any difference between the current market value and the initial contract price is added to, or taken away from, the margin account that is held through the broker with the clearing house.

Sophisticated investors and risk managers are aware of the principal differences distinguishing exchange and OTC options: exchange products (ETOs) are standardised in size, quality, location, and delivery time, are backed by the credit of the exchange clearinghouse, are subject to exchange regulations on margining, and can be traded readily over the duration of the risk. OTC instruments can be customised over the parameters above, carry specific counterparty credit risk, are not subject to exchange margining, and cannot be traded readily over the duration of the risk.

While some US-based hedge funds suffered large losses in 1998, ASX is not aware of any significant financial institution operating in Australia that experienced similar problems. In this event, either the current Australian legislation is sufficiently effective so as to prevent an excessive accumulation of liabilities, or the current set of market participants did not behave in a manner analogous to that of failed US fund managers. It is difficult to assess the validity of these interpretations in the absence of Australian case studies, which have been used to investigate weaknesses in the US system.

Nevertheless, ASX wishes to briefly comment on the recommendations of US financial regulators, which have recently issued a report on the need for regulatory reform[7]. Importantly, the report does not recommend widening the coverage of existing legislation to ensure that hedge funds are directly regulated. This outcome suggests that there are limits to the capacity of regulation to treat the specific requirements of hedge funds. In particular, leveraged investments transferred hedge fund liabilities to banks, so

[7] 'Hedge funds, leverage and the lessons of Long-Term Capital Management', Report of the President's Working Group on Financial Markets.

improving the regulation of the banks has been seen as preferable to widening the regulatory net to cover hedge funds.

The report recommends that increased reporting of hedge fund activities be required. In addition, the report recommends that public companies, including financial institutions, should publicly disclose additional information about their material financial exposures to significantly leveraged institutions, including hedge funds.

**ASX recommends that detailed analysis of the reporting requirements of relevant financial institutions be undertaken before similar recommendations are made in Australia. It should be established that more detailed and frequent reporting creates a significantly better informed marketplace.**

One issue is that, by their nature, the risk associated with the investments of some funds can change markedly in a short period. Where a particular investment strategy is not disclosed to investors, it might be that the fund exercises independent judgement about the immediate investment opportunities. In this respect, reporting requirements may mislead rather than inform, if investors assume that the structure of investments identified in the most recent report instalment reflects the future intentions of the fund managers. While this argument can be made about most forms of financial reports, it is most pertinent to funds that do not make public their investment strategy.

These issues also arise in proposals for disclosure requirements for public companies. Some companies already report hedging that is undertaken internally, such as currency hedges that are made for the purposes of trading activity, in their financial statements. In this type of information, the company's position is unlikely to fluctuate greatly between reporting periods.

Extending the financial reporting obligations to include investments may prove to be a difficult exercise for some public companies. The President's Working Group report recommends that public companies, including financial institutions, should publicly disclose a summary of **direct** material exposures to significantly leveraged financial institutions. A potential difficulty with this approach is that if the public company's exposure exists through indirect investments, then the value of the information might be diminished by a complex chain of obligations that do not lend themselves to simple comprehension (which is the problem that is under examination). **Further analysis of the value of reporting obligations for public companies must be undertaken before an appropriate position can be developed.**

As noted above, the US Working Group report suggests that improving the existing regulation of the banks is preferable to widening the regulatory net to cover hedge funds. Reforms were suggested to make financial institutions enhance their practices for counterparty risk management. The objective is to encourage banks and securities firms to demand better information disclosure from borrowers who are known to be using funds for highly leveraged investments.

The Committee might consider the work of international agencies on this subject. For example, the Basle Committee on Banking Supervision's has made a recent report outlining sound practices for banks' interactions with highly leveraged institutions. The International Organization of Securities Commissions ("IOSCO") has studies underway, which should be relevant to the Committee's objectives.