Corporate Public Affairs Oration

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Globalisation of Capital Markets: Implications for the Australian Community

Delivered by

Richard Humphry, AO

THE CENTRE FOR CORPORATE PUBLIC AFFAIRS

Foreword

This is the eighth Corporate Public Affairs Oration. Previous Orations in the series have been:

1994 The Hon John Dawkins, former Federal Treasurer, *Business-Government Relations: a decade of economic reform and the role of business*

1995 Mr John Prescott, Managing Director and Chief Executive Officer, BHP Company Limited, *Business in its Community: forging a new partnership*

1996 Mr John Ralph, AO, Chairman, Forster's Brewing Group Limited, *A corporate social responsibility?*

1997 Mr W Frank Blount, CEO Telstra Corporation, *Convergence or Collision? Emerging complexities at the business/community interface*

1998 Mr M A (Tim) Besley, AO, *End of Millenium Challenges for Business, Government and Society*

1999 The Hon. John Howard, MP, Prime Minister, *Corporate Community Involvement*

2000 Mr S D M Wallis, AO, Chairman AMCOR, Coles Myer, and AMP, *Corporate Governance - Conformance or Performance*

The Oration has two objectives:

- to extend knowledge about public affairs management. It seeks to do this by providing a forum for those who have made a distinguished contribution in related areas to reflect on their experience and thus contribute to understanding of the function and the sparse literature in the field; and
- to focus attention on the nature of the social and political environment. The Oration seeks to illustrate why and how successful management includes in its vision and practice constructive engagement with its communities.

Through the wide distribution of the Oration and through the other activities of the Centre for Corporate Public Affairs we seek to further these goals.

The Oration was delivered at a Centre dinner held in Melbourne on 28 June 2001.

Oration

Globalisation of Capital Markets: Implications for the Australian Community

Richard Humphry AO,
Managing Director & CEO, Australian Stock Exchange

I appreciate the opportunity to speak to you tonight about the Globalisation of Capital Markets, and the Implications this has for the Australian community.

It's a topic that is vitally important for the continued success of the company I lead – and moreover for all Australians.

Tonight I will focus on one particularly important aspect of this – the question of whether Australia will remain a suitable location for corporate headquarters. It's a question that is emerging as increasingly central in the whole globalisation debate, so I want to outline the problem and to suggest some appropriate responses by government and corporates.

A few weeks ago, protestors from the M1 group blockaded ASX offices around Australia. M1 was mounting a global anti-globalisation protest – in itself an interesting sign of the times - and they made ASX a focus of their protest by trying to shut us down for the day.

The protest was not violent, and physical blockades pose no threat to electronic markets, so May Day was very much a 'trading as normal' day for us.

But I mention it tonight because it goes to the heart of my theme about Globalisation and its Implications for the Australian Community.

GLOBALISATION IS NOT A BIG END OF TOWN ISSUE

M1's central proposition, as I understand it, is that real power today is exercised not by governments, and certainly not by people, but by large and unaccountable corporations, whose activities produce negative outcomes for the environment, for labour rights, for farmers, and so on. It follows that markets, such as ASX, are just the willing handmaidens for corporate power, and hence we are the appropriate targets for the protests.

I don't accept that line of argument – for reasons that I will outline – but I do find some common ground with M1. It should go without saying that in a global world, corporates need to behave decently. It is not acceptable to destroy a local environment for the sake of short run economic activity. Workers should be treated, wherever they are, with respect and dignity. This is good business practice.

I also share with M1 a sense of urgency about the situation we are facing.

But I do reject any suggestion that globalisation is just a big end of town issue – where the corporates are the winners and the ordinary people are the losers.

Far from being a big end of town issue, globalisation is an issue for all Australians. It impacts on all of us – because it is ultimately about our national prosperity or, even more simply, it is about whether there will be enough jobs for Australians, and whether they will be good jobs.

I particularly reject the criticism of markets. If we are serious about protecting Australia's national prosperity, and serious about ensuring that Australians retain some degree of control over their future, then we must recognise the positive and central contribution that capital markets can make.

A deep and liquid capital market is an absolutely vital ingredient of national prosperity and in these times it is one of the best protectors and guarantors of national prosperity and self-determination.

It works like this. Markets bring together buyer and sellers, whether they are fruit markets or capital markets. Capital markets bring together investors, who have capital, and companies, who want capital. Liquidity is simply the measure of how easy it is for investors to convert their investments into cash or other investments. And depth is a measure of size – so a deep market provides a wide range of choices.

So in deep and liquid capital markets, investors have confidence that they can buy and sell quickly and easily and efficiently.

The more liquid and deep a market is, the more attractive it is to investors.

Liquidity and depth is good news for the companies, too, because the more investors there are bringing capital to the market, so the cost of accessing that capital falls. A deep and liquid market improve a company's price-earnings ratio – pushing the share prices higher and thus rewarding companies for participating in the market. And with cheaper capital, companies can grow more easily and create more jobs.

It is as simple as that – a virtuous circle in which job creation and wealth creation grows in part as a function of the liquidity and depth of capital markets.

In other words, efficient national markets are not part of the problem of globalisation. They are part of the solution.

I know that any audience convened by Geoff Allen has more than its fair share of people with an appreciation of public policy issues. But I am not aiming tonight to just win a public policy debate. This is an issue of urgent importance for all Australians.

We can't just wish globalisation didn't exist and pretend that everything will come out all right in the end. Big changes are happening in the way the world works, and if Australians don't understand them and deal with them effectively, we may end up as not much more than a global holiday destination – and certainly will not realise our potential as a nation.

And that must impact on our objective of a growing standard of living, maintaining an egalitarian society and being able to provide our children with the opportunities in education and employment and life style that we have enjoyed.

On the other hand, if we do keep at the task, and build on what we have done so far, we have got a chance.

So – let me begin with where we are.

THE NEW AUSTRALIAN ECONOMY

As we all know, Australia's economy and society today has undergone a sweeping transformation over the last couple of decades:

– from an old economy built around farm and mining products and, in the post war years, some manufactured products – to a new economy that is strong in services such as telecommunications, finance, education and tourism

– from a protected and centrally regulated economy to a largely open, market-oriented economy

– from extensive public ownership via government shareholding to extensive public ownership via individual shareholding

– from a savings regime anchored around the quarter acre block to the superannuation guarantee.

To illustrate this transformation, let me give you some figures:

- Ten years ago, in December 1990, the Australian stock market was capitalised at about $138 billion.
- The resources and manufacturing sectors together accounted for about three-quarters of that total. Finance and insurance was capitalised at just $22 billion.
- The liquidity of the market was just 32 per cent – that is, only about one-third of the total market capitalisation changed hands each year.

Ten years later, at the end of 2000, total market capitalisation is $670 billion with a very reasonable liquidity level of about 60 per cent.

- The resources sector has nearly doubled to $94 billion. Manufacturing has nearly tripled to $130 billion.
- But finance and insurance is valued at $246 billion: more than resources and manufacturing put together.
- And meanwhile, a section called "other service" – which includes media and telecoms – has gone from $14 billion to $200 billion.

- So about two-thirds of the total value of the market is now provided by service industries.

Financial services alone now accounts for about 7 per cent of GDP, contributes more than $A40 billion to GDP, is growing at an average 8.5 per cent a year, exports some $1.6 billion of services a year and employs more than 300,000 people.

Our stock market is the 10th largest in the world, with turnovers of up to $3 billion a day and a total capitalisation that is about 110 per cent of GDP.

Both Government and the Opposition have supported growth in the financial services industry over the past decade and we are seeing further evidence of the present Government's commitment to building the financial services industry.

The Financial Services Reform bill, currently before Parliament, will deliver further improvements and clarifications in the regulation of the entire industry. And in a few days time, July 1, as a result of an initiative of the Commonwealth Government with the cooperation of State governments, we will see the abolition of stamp duty from buying and selling of listed securities – removing a significant impediment to share trading and giving all investors greater confidence in the Australian marketplace.

For most of our history, Australia has been a major producer of agricultural and mining products. The wealth of our natural resources gave us a head start, and with hard work, adaptive technology and a focus on exports, we built world-class industries. As an interesting sideline, the farming sector has been all but absent from our financial markets – though there are some signs that this may change.

In building services-based industries over the last couple of decades, we obviously didn't have the same kind of natural advantages – the same mountains full of iron-ore – that gave us a head start in the primary industries. (I exclude the tourism industry, which is of course all about natural resources.)

What we do have however is human resources – smart people with strong skills – and this is the essential requirement for success in the global economy.

There is a lot of rhetoric in the anti-globalisation argument about "McJobs" – the spectre that the only jobs available for our children in a global future will be low-skilled, low-wage part-time jobs.

The reality about employment opportunities in the services sector, including financial services, is very different. As a visit to any of the financial institutions in Sydney or Melbourne will show, the rise of financial services has created a workforce that is young, highly skilled, career-oriented, multicultural, and merit-based.

Financial institutions are very well-equipped in Australia with people who have the specific skills for trading, banking, operating financial markets and so on, along with allied professions such as accountancy and law. A measure of the high standards of the Australian markets is that they have bred large numbers of Australians who have outgrown the local markets and pursued their careers into senior levels with global institutions around the world.

I know the financial regulators are in the spotlight at present but the fact remains that led by the Reserve Bank, Australia's regulators have a very high level of capability and credibility, and this underpins the integrity of the entire financial industry.

Australia also has a capable and indeed world-class infrastructure of technology –the systems that provide the electronic and internet-based trading platforms and communications networks. Again, there are opportunities for people to operate these systems effectively while also innovating with new ideas and procedures.

> ASX is a perfect example of this, since we are fully reliant on electronic systems for trading, clearing and settlement. Thanks to an excellent performance by our systems teams, our markets operate with about 99.8 per cent reliability – better than that of the New York or London exchanges.

The point is, the economic transformation in Australia over the last couple of decades has created excellent job opportunities for young Australians and has created a great pool of high-value-adding skills that are integral assets in the global era.

SCALE – DO WE MATTER?

So, given this sweeping societal and economic transformation, Australia should be pretty happy, yes?

Well, maybe.

But just remember scale. Australia's performance and strengths in many areas is world-class, in a relative sense. But in an absolute sense we are scarcely on the radar. By world comparison:

our GDP is small;

our population is small; and

we command a small proportion of the world's capital.

We can quantify this by reference to the MSCI – the Morgan Stanley Capital International index, which is the benchmark used by global fund managers and other investors to allocate capital to stocks around the world. Given that investors are increasingly measured against their performance relative to the MSCI benchmark, it is a hugely influential guide to the relative capital attractiveness of the national economies of the world.

- which is why it is better known as the Finger of God.

Under the latest MSCI weightings, Australia is allocated 1.36 per cent of global capital. The good news is that this is up from our previous level. The real news is that at 1.36 per cent, we are a minnow compared to Japan (11.2 per cent), the United Kingdom (9.8 per cent) and the US (52.7 per cent).

This helps to explain that feeling you have if you visit New York's financial district, and realise that hardly any one there is well informed about Australia and even fewer of them care.

That reaction says as much about New York as it does about us of course – they regard foreign news as what's happening in California. But it is true that Australia is only just at the edge of relevance in the global economy.

This issue of scale is the major and most urgent challenge for the foreseeable future – for governments, corporates, markets and policy makers. How can we ensure we do not fall off the map entirely? How can we ensure we remain relevant and thus able to influence events in our favour?

In highlighting this, I am not talking textbook hypotheticals. You can find a real life example of the problem of scale by looking across the Tasman at New Zealand.

While Australia's market capitalisation has risen so strongly, the New Zealand market has actually been shrinking for the last few years – from $A48 billion in 1997 to around $A35 billion today. New Zealand's share of the trans-Tasman marketplace has more than halved since the mid-1990s and is now only about 5 per cent.

On the Finger of God index, New Zealand represents just 0.05 per cent.

Many of the biggest New Zealand companies have quite simply outgrown the New Zealand capital market and are now listed on the Australian Stock Exchange. That has been our gain, but at significant cost to the Kiwi economy as a whole, and in particular to those enterprises who for various reasons can't or won't move out of their home market and are thus burdened with the higher capital costs there. This is despite the fact that New Zealand has an efficient and low-cost stock exchange.

But surely this couldn't happen to Australia.

The problem is: it could.

BHP-Billiton is now a dual-listed entity listed on both the London and the Australian exchanges. Brambles, NAB, and others including CSR just last week, are spoken of as possible Australians likely to consider moving offshore in whole or in part.

Why do Australian companies seek listing offshore? The simple reason is that they believe this course offers them the best chance of survival and growth.

The challenge for policy makers – and for ASX – is to provide them with the best possible environment to grow while remaining domiciled in Australia. Certainly, many of ASX's recent initiatives, which I will come to shortly, are directly aimed at this. And some good news is that to date, dual listed companies have retained their share of liquidity and depth in Australia.

However, consider Australia's current taxation arrangements, which currently have the effect of penalising Australian companies that grow their activities offshore.

For example, dividends paid to an Australian head office from its subsidiaries offshore are subject to 15 per cent withholding tax in the offshore jurisdiction.

Some years ago, Australia unilaterally removed withholding tax on franked dividends paid by foreign companies in Australia to their foreign shareholders – but we have failed to ensure that this same facility applies to our own multinationals. We hope that this problem will be corrected, including through the current US-Australian double tax treaty negotiations.

Similarly, Australian companies are unable to stream foreign sourced income to foreign investors and domestic income to domestic investors – in effect, wasting franking credits that could otherwise encourage both Australian and foreign investors to buy their stock.

These issues need attention because they are making Australia a less attractive location for corporate headquarters.

Losing head offices means losing critical mass. It means becoming a branch office economy.

It means the loss of billions of dollars of company tax revenue; the loss of strategic decision-making power and strategic decision makers; and the erosion of the all-important skill sets I mentioned earlier – all the professional value-adding skills that are important in themselves and that also have a knock-on effect in creating other jobs.

A further problem is that companies are encouraged to move offshore because they believe they will find deeper pools of liquidity in the larger markets of the US or UK.

I mentioned earlier the virtuous cycle of liquidity – the greater the liquidity, the more confident the investors and the cheaper the capital.

The departure of significant listed companies could breed a vicious cycle of illiquidity: reducing liquidity, deterring investors and making capital more costly for the remainder of the locally listed companies – depressing Price/Earnings ratios and shrinking prospects for economic growth and jobs.

What are we doing in Australia to meet this challenge?

POLICY CONUNDRUM: OWNERSHIP VERSUS COMPETITION

Putting aside the Pauline Hanson remedy – which appears to be nothing more than pulling up the drawbridge – the policy debate is running along two alternative tracks.

On one hand is the argument that we should concentrate on a number of short run domestic goals, especially increased consumer choice and lower consumer prices, through ensuring domestic competition. This requires a fragmented industry model such as we have in airlines and the four pillars of banking. The implication is that who owns Australian companies is less important than ensuring they operate in a competitive framework under strong Trade Practices legislation. Thus both Qantas and Ansett have taken significant alliances with foreign companies.

One of the stated purposes is to build the so-called national champions – Australian companies able to build a significant presence in the global marketplace. Ten years ago in the United States, Harvard academic Michael Porter became associated with this argument. He suggested that it was only via strong domestic competition that champions would emerge strong enough to take on wider leadership roles in the global economy. That seemed to be the experience in the United States.

The opposite argument says the ownership structure of Australian companies does matter, and that in some circumstances foreign ownership is not acceptable. The Shell/Woodside decision was a good recent example, and the Foreign Investment Review Board retains similar powers over banking, the media and other industries.

To me, the issue remains a puzzling conundrum. I can’t resolve it for you tonight.

There are reasonable grounds to be dissatisfied with the competition model. The airline industry to me looks like a policy failure or at least not a policy success, because all it has produced is a duopoly with significant foreign ownership – as opposed to the Australian-owned duopoly we grew up with in the post war decades. The emphasis on domestic competition – and the reluctance to consider global competitive pressures – also does seem to prevent Australian companies from merging to become large national champions.

Further, I am suspicious of the Michael Porter argument because it may apply only in very large economies such as the United States. There is no guarantee that it works in smaller economies such as Australia where the market may not support more than two or three major domestic competitors. One size does not necessarily fit all when it comes to national champions.

Equally, it is vital that Australia continue to be attractive to foreign investment.

But my deepest concern is this: neither the Trade Practices side of the argument nor the Foreign Investment Review Board side of the argument focuses on the major emerging question: how to keep Australian companies headquartered in Australia.

The competition model is not primarily interested in the location of the headquarters. The foreign investment model might breed large Australia national champions – but there is nothing to suggest that a national champion will remain based in Australia.

So no matter which model we adopt, we are still at risk of losing our headquarters.

Whether they grow through competition or through merger, it is important that leading Australian companies not only operate in Australia but also remain headquartered in Australia.

It is not really surprising that the competition/foreign ownership debate has been overtaken by events. Both the Trade Practices Act and the Foreign Acquisitions and Takeovers Act date to the 1970s. Thirty years ago, issues of globalisation were not on the agenda. The idea of the headquarters of icon Australian companies emigrating offshore would have been unthinkable.

The Acts also predate all but a handful of the members of the present Parliament. That is, the current crop of MPs has never had to fully debate these sensitive and important pieces of legislation, or their relevance to the urgent issues of globalisation, the branch office economy, and the vicious cycle of illiquidity.

I think it is time for such a debate.

AUSTRALIAN STOCK EXCHANGE'S STRATEGY

I couldn't complete this presentation without telling you a little about what the ASX itself has been doing and how we are placing ourselves to cope with the global environment.

ASX came into existence as a single national market in 1987 on the back of the six separate state-based markets that had operated since before Federation. They did so to build a critical mass and to overcome the fragmentation of Australian markets.

At the same time, we introduced electronic trading with the SEATS system, in place of the open-outcry method.

> It is surprising how many people still come to our building expecting to see chalkies running up and down ladders being shouted at by brokers. Trading now takes place on a fully electronic basis and the market exists only on the screen in the hundreds of offices in broking firms around the nation.

SEATS allowed for the first time, all Australian investors wherever located, to access the same information on all Australian stocks, at the same instant in time.

Another major achievement was the automation of clearing and settlement via the CHESS system in 1994.

On this basis you could say ASX is a change-capable organisation, and this was fully borne out in the decision in 1996 to demutualise and, instead of being owned by the stockbrokers, to become a listed corporation on our own market. We were the first market in the world to take these steps simultaneously. In place of the original 606 brokers we now have a shareholding registry of 17,000 mostly small private investors.

The markets in Singapore, Hong Kong and Frankfurt have followed us down this path, with London, Paris and Nasdaq set to follow.

I was delighted to hear recently, that when the President of the New York Stock Exchange was asked where he would like to be in 5 years time, he said: "Where the ASX is now."

But we have a major challenge ahead of us to ensure that we remain relevant: we need to ensure the continued liquidity and depth of Australia's capital markets.

There are three legs to our strategy to address this.

First, we will continue to perform our core responsibilities well – that is, maintaining a fair and orderly market.

Second, we can expand the range of products that are traded on our market – beyond the core of equities and derivatives. For example, we are working to build new markets in interest rate products – that is, government and corporate debt – and in ETFs – Exchange Traded Funds.

I will digress briefly to add that we are very keen to develop a retail market in Commonwealth debt.

> Over recent years millions of Australians have been able to diversify their investments away from the traditional quarter-acre block. Thanks to the privatisations and demutualisations, and the growth of compulsory superannuation, many Australians now have a better exposure to shares. Indeed, Australia has one of the highest levels of shareholding in the world.
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> But wider diversification is better still, and what more sound and more liquid form of investment is there than Government bonds? Strangely however, that most secure and conservative of all possible asset classes – sovereign debt of the Commonwealth of Australia – is not directly and readily available to individual Australian investors, or tradable by them.
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> A key impediment is that the Inscribed Stock Act of 1912, which naturally predates the electronic era, does not allow for electronic settlement of Commonwealth Government Securities.
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> I am happy to report that Treasury is hopeful that Parliament will deal with the necessary amendments in the spring session. Having become a nation of shareholders, this development might lay the foundation for Australians to become significant holders of bonds as well.

Our third leg of ASX strategy is to build linkages with foreign markets.

I will start by emphasising that I am not talking about mergers here. We recently had a very long look at a merger proposal with the New Zealand Stock Exchange but decided not to proceed. We found that questions such as: whose currency is to predominate? and, whose regulator is in charge? and what are they in charge of? were too difficult to resolve, because they raised fundamental and emotional questions of sovereignty.

A much sounder strategy is to build market linkages, and we have recently initiated a trading link to the United States, and we are working on a two-way link with the Singapore Stock Exchange.

We think it is important that Australian investors can get ready access to the other 98 per cent of the world's best share investments. The attraction of being able to invest in some of the leading brand names in the US economy is a tempting one – but currently it's not easy to do so. At the same time, we want offshore investors to be able easily to invest in Australia.

ASX World Link is designed to make investing in international securities as easy and convenient as trading and settling ASX quoted securities.

I am emphasising this not only because it has long-term potential for the growth of the ASX but also because it is linked to my central theme of building more liquid markets.

It is in the interests of Australian investors to be able to access a wider range of assets in foreign markets, and to do so under prudential arrangements with Australian regulators and with the convenience of their own broker. Equally, Australian companies benefit because they can tap a wider pool of investors without leaving these shores or needing to establish dual-listed structures. They should be able to find that the most deep and liquid market for their stock is their home market.

We have already had discussions with the Hong Kong Stock Exchange, and whilst no decisions have been made they will certainly monitor the Singapore link with close interest. The London Stock Exchange is also interested in cross-border trading and we have recently been in contact about ASX's initiatives.

Taken together, we believe that these strategies will help build the kind of environment in which Australian listed companies can remain just that.

CONCLUSION

Broadly speaking, I am an optimist. I am very concerned about the challenges of globalisation, but I also think the race is not yet run – and Australia is a robust and capable place.

But we do have to understand that global economic forces are real; and they are gigantic.

Unlike the protestors of M1, I don't think there is much value in having a street protest. But perhaps we are engaged on the same side of the same battle. There is common ground in a deep concern about how to ensure national prosperity.

What about the policy response from governments? I don't buy the argument that sovereignty is dead or that the forces of globalisation are driving the regulators to spiral downwards in the so-called race to the bottom – that is, the adoption of the lowest standards rather than the best standards.

It is more vital than ever before that we develop and deploy policy that works – policy that meets the needs of the times.

Tonight I have pointed to a number of issues that need attention. We need a taxation system that makes Australia attractive as a head office economy, not a branch office economy. We should debate the Trade Practices and Foreign Investment legislation from the same perspective. We need to ensure that – both through our education system and our open and non-discriminatory immigration policy – we continue to be a society that produces capable and skilled people to fill challenging and rewarding jobs. We need to facilitate continued exports of Australian goods and services.

And we do need to recognise the central importance of liquid capital markets as an underpinning of our national prosperity. This is not special pleading – just the sober facts.

Australia can survive and prosper in the global world – but we are going to have to be very smart and very focused to do so successfully.

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