WHERE WILL THE CAPITAL COME FROM?

Address by R.H. Carnegie
to
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Finding enough capital is of fundamental importance to the future of this nation. The preparation of this talk has involved some research into past facts and figures which has proved to be quite illuminating. Some, if not all, of the facts outlined will be familiar to you. I want to question, however, whether any of us are doing enough to inform opinion leaders and others outside the capital markets of the seriousness and urgency of the problems.

Five basic generalisations are a good starting point for today's talk:

- You can't consume if you don't produce
- You can't produce if you don't invest
- You can't invest if you don't save or borrow
- You can't save without foregoing consumption now
- You can't usually borrow without paying servicing costs and repaying capital.

These basic truths are fundamental. They are, however, not widely understood in Australia, and for this reason they make a good starting point.

Supply and demand are basic factors in a business or an economy. In finance, demand for capital is related to investment, supply of capital is related to savings. My talk today will skim quickly over the demand side and concentrate more on the supply side difficulties facing Australia.

Investment means different things to different people. For most Australians, their major investment is a house. For businessmen, investment is a basic requirement for continuing production and essential for future expansions. For governments, investment is needed to supplement other taxes and revenues to meet social and economic objectives.

My beliefs are:

1. Capital is essential for a free enterprise society. It is new investment which lifts productivity, real wealth and real living standards.

2. Australia needs substantial new investment to create meaningful jobs for the rising numbers of people in the working age group. Enough jobs, and worthwhile jobs, must remain at the forefront of national objectives.

3. The economic facts of life are that Australia can best go forward by building on strengths and, if necessary, gradually phasing our weaknesses.

4. We are a high wage country. So we must put an increasing proportion of new resources into those capital intensive, high productivity growth sectors where we have demonstrated our international competitiveness.

5. There are material benefits, both political and economic, if Australia can increasingly supply more capital from its own sources. Some of the reasons why that has not been possible in the past are fading in importance.

So, we must ensure that our capital marshalling apparatus delivers an adequate supply of finance on competitive terms and conditions.

Background

First some history. When the Second World War ended, the scars of the depression and the war acted as a spur to all sections of the nation.

There was common agreement on basic national objectives: full employment and growing population, industrial development, better housing, etc. Growth was an accepted objective. People were then ready to work and save for a better future. There was a consensus.

But things have changed. A life style with a high degree of commitment to financial security, and to economic growth now seems unattractive to many younger Australians. Expectations have been universally raised so that "Spend now: pay later" rules supreme. Our consensus is in question.

At Federation, it was said the Federal Government would cost "less than the price of a dog licence per head of population". Some dog, some licence! The Loan Council, dating from 1928, regulates the volume of borrowings, limits interest rate competition, and provides a Commonwealth Guarantee. Its introduction marked the dominance of the Commonwealth over the States in financial matters.

The collapse of the Australian money markets in 1928-1929 was an essential part of the capital market story, because it limited the States' ability to borrow and thereby curbed their spending. Some problems don't change.

The need for some constraint on Government spending, and the subsequent problem in meeting interest on foreign debts, brought home to Australian governments the unpleasant disciplines of foreign markets and central banks. This was in the days before Keynesian economics was fashionable.

This salutory experience meant that government borrowing overseas fell out of favour, as you will see in the few charts I will show later. Instead, governments pre-empted a major share of the domestic capital market for themselves.

The Second World War required the mobilisation of all resources. This included the abolition of State income taxes, the introduction of exchange controls, interest rate reductions and controls, credit rationing plus tight bank liquidity controls. Our bureaucrats became addicted to these all-embracing controls. The Labor Government post-war was in no hurry to dismantle them, nor were the Liberal/Country Party Governments which followed.

The monetary history of the fifties and sixties is littered with the failure of direct control experiments rather than reliance on the forces of the marketplace. All Australians have suffered by these policies, which have seriously distorted our national ability to mobilise savings and use the capital creatively.

Firstly, the trading banks bore the brunt of the attack. The Reserve Bank attempted to dictate who they could lend to, how much, and the interest rate. Liquidity controls sapped their competitive position. They were shackled in competing for deposits and loan business. Profit constraints limited their ability to innovate. The inevitable result was new financial organisations sprang up, operating outside the Reserve Bank restrictions, but lacking the basic strength of the national banking system.

From the banks' point of view, their compensation was a monopoly of foreign exchange facilities and the absence of direct competition in their domestic banking business.

The outcome of all this is that customers in Australia lack competitive facilities and, when they do venture abroad, they lack the support of their own banking system which is so characteristic of many of our competitors. The lack of leadership by our financial community in seizing the opportunities in the emerging Pacific Basin region in the early 1970's is but one example of the cost to Australia.

The savings banks have been subjected to similar controls. Originally they had to maintain 70% of deposits in government securities or money on deposit with the Reserve Bank. Even at the present 45%, the sheer size of funds so trapped by governments is enormous, if you remember that savings bank assets now exceed $16,000 million.

Pension funds and life assurance companies had the 30/20 arrangements foisted on them in November 1960 in return for some tax concessions. A significant part of the funds of our largest financial intermediaries are thus trapped in value losing government bonds as we shall see in the charts.

You will note the common pattern in these regulatory developments. The Government pre-empted for itself a prime position in the limited Australian capital markets, not on the basis of its undoubted competitive attractions, but on the basis of compulsion. Private sector borrowers, other than those seeking housing finance, were forced to seek equity and debt requirements from the funds remaining, or seek funds abroad where frequently they were required to surrender equity. The mining companies, as one example, were forced offshore.

We thus have a situation of governments pre-empting for themselves a favoured share of available long term sources of capital. Furthermore, the system operates to give the governments an interest saving. If one looks at a sophisticated market such as New York, you will find a triple A rated borrower paying something of the order of 0.25% above government bonds of similar long maturities. In Australia the margins are 1-2%.

Two further facts need to be noted.

Firstly, our taxation system has tended to discourage long term blue chip investment, since dividends in the hands of individuals are taxed twice. The issue of the taxation of capital gains in Australia, lacking certainty and clarity, has also tended to weigh against stock exchange investment as compared to other forms of investment.

Secondly, we must note the extremely difficult area of regulation and control of our stock markets within a legal framework which gives everyone confidence and creates the image of the free market system at its best.

(Charts which sum up some of these developments are reproduced at the end of this paper.)

Savings

Now let us turn for a few minutes to the aspect of savings and savers. That Australians have a relatively good savings record is well known. However, the cumulative effect of changes over the last decade is not always appreciated.

Again for reasons of time, I will merely make six points:

1. Household savings increasingly dominate the net additions each year. Government and company savings are small by comparison, even given the present recovery in company profits.

2. There is strong growth in savings deposits and building society deposits plus short term fixed interest investments such as mortgages or finance company paper. "When in doubt, stay short".

3. The distribution of wealth and income in Australia is changing — difficult to document, but strongly suggested by observation. The two wage earner family, each earning from average weekly earnings to twice that figure, and with mortgage commitments reduced to small sums by inflation, are collectively the new rich rather than the traditional middle class groups.

4. The quarter acre block dominates our private asset structure. One estimate last year put the market value of all dwellings in Australia at over four times the market value of all listed shares. If we were to add the contents, the cars and boats, etc. this multiplier would rise to five or possibly six. The quarter acre block is dominant for good reason. Its record of preserving real value, and the ability to borrow on preferential terms on the asset, has made it an outstanding investment in Australia especially during periods of high inflation. We have no other assets widely understood by the majority of Australians, particularly by the "New Rich", which match the performance of a highly geared investment in a dwelling.

5. As noted our institutional arrangements have the effect of channelling the bulk of long term capital into captive government debt or housing. The rest of the private sector, needing long term equity and debt support, is starved. If we look at new equity money raised by listed companies in Australia last year we see a "record" $472 million — in real terms this is about the same amount as 5 or 15 years ago. Just consider that: no real growth in 15 years or so. What proportion

of Australians still have never bought or sold on a Stock Exchange?

6. Foreigners confidently invested their savings in Australia in the 1950's and 1960's. They took note of that welcome mat, the clear rules governing their position which assured non discrimination, and thus invested long term. Today, some foreign investors are wary about new ventures, especially where Australia's twin problems of high wage/low productivity are evident. Like elephants, many overseas investors remember sabre rattling, nationalistic speeches and incidents of government intervention long after the original participants have retired from active politics. Furthermore the flow of profits from earlier investments is rising as we have seen.

If we look for an explanation of what is really at work in the underlying trends in social behaviour upon which ultimately these savings and work habits are based, we enter much more difficult territory. My hunches are based on some simple ideas.

Savers put money aside from their current income making a conscious decision not to spend today. If they gave up buying a new item costing $100 today, they expect that this deferred consumption will at least enable them to buy a year or so later what they gave up buying today. Maintenance of the real value of deferred consumption is, I believe basic to the saving habit. Some interest earned for the act of deferment is also a factor, but I believe less basic.

Household investment decisions depend upon many factors depending upon age, dependants, education, income, experience, etc. A democratic society aims to educate people in the consequences of their investment choices, and trusts them to choose wisely. It assumes reasonably stable currency values.

But, by and large, most Australian Governments have found it easier to tolerate inflation, thereby automatically gaining tax revenue and debasing fixed interest bonds issues. People have failed to see the significance of this and hence chose poorly — until recently. Governments selling risk free bonds are like a charlatan selling snake oil — you may trust them for a while.

Many family groups have limited knowledge of where to put their savings. They go to the institutions they know even though they know that interest rates do not always cover inflation. The institutions preferred seem to be the sources of housing finance, and the sources of consumer durable finance — where most of today's savers got their earlier loans when their financial position was less secure. When in doubt they seem to prefer to keep the investment short.

Householders know what they don't like. They are suspicious or ignorant of stock market investment, or government bond purchases, or longer term contractual methods such as life assurance. I think this major generalisation holds up despite more recent successes such as the Australian Savings Bond.

All these underlying trends create a real challenge to the long term working of the free capital market which is, I believe, a fundamental underpinning of the private enterprise society and of a property owning democracy.

The Challenge

So there is a real challenge because new patterns of savings and savings mobilization do not seem oriented to wider community expectations. I can only guess at what those expectations are, since we seem to be embarrassed if national objectives are proposed. My guess would be that we could find a new national consensus in some combination of the following aims:

- high and rising living standards for all Australians
- satisfying, rewarding work for those seeking jobs
- improvement in the quality of life
- improved participation in decision making
- a sense of ownership, not just of one's own home, but in the wider sense of an Australian property owning democracy.

These objectives should be agreed in a society which is vastly different from that of a generation ago. Australia is not now growing so quickly, and we must adjust to a somewhat smaller and older than expected population if the best allocation of resources is to be made. This is an important opportunity for the private sector to grasp.

The major challenge lies ahead: how to marshall the vast long term capital needs of the private sector. Our savers know what they are suspicious of: we have to reach them in new ways.

Here are six ideas to start the ball rolling:

1. Governments should compete for funds on merit, not compulsion. This would very likely mean higher interest rates initially, which would suit savers. It would be wholesome exposure to market forces for government planners at all levels.

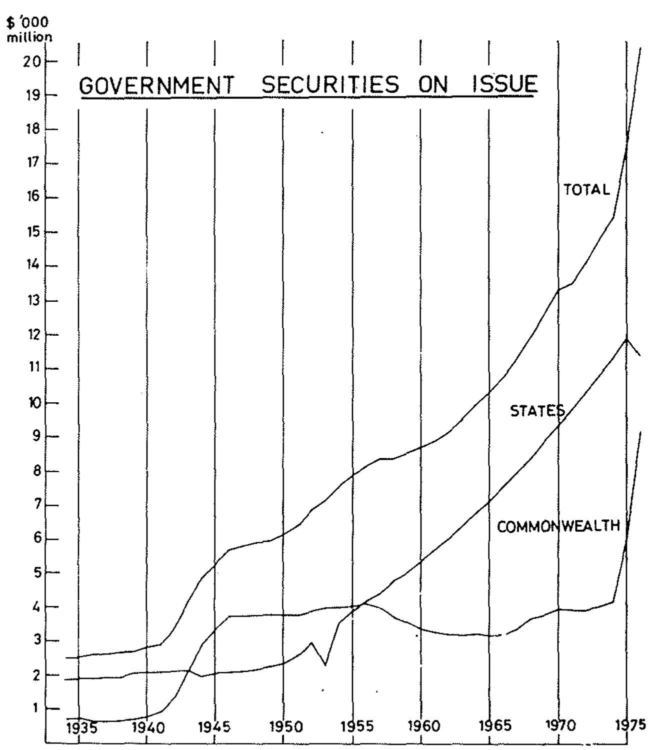
2. We should encourage our major long term savings institutions to commit more resources to the private sector other than housing. We need to unshackle them and let in some healthy competition. We should abolish the 30/20 rule and widen savings bank investment portfolios.

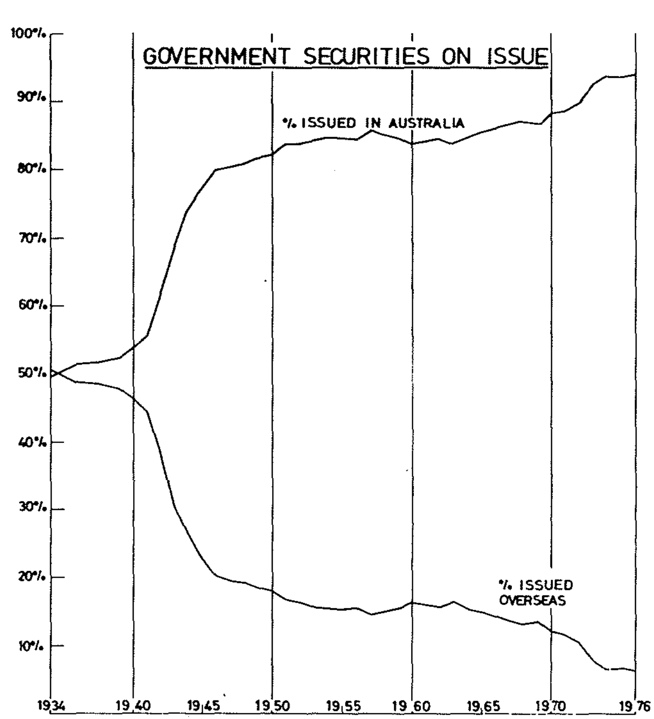
3. We need a vigorous and competitive banking system. Their spread of branches across Australia is a unique asset. We should ensure that they are competitive, innovative and not unduly protected by monopoly privileges. Their foreign exchange monoply for example is a relic of the past which requires justification or abandonment.

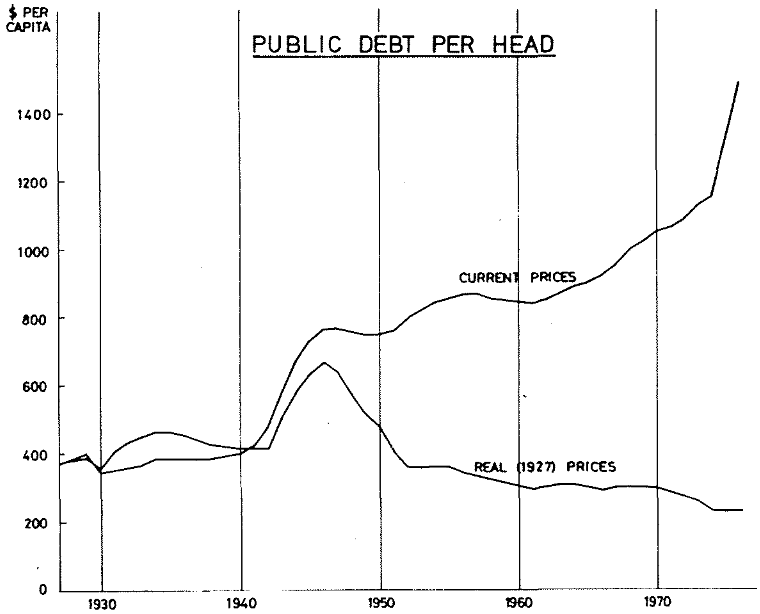
4. We should re-examine the merits of opening our capital markets to the rest of the world. We should have little to fear from the competitive forces which might result, and we would stand to gain if our industries were backed by a forceful, competitive and innovative Australian capital market. We should gradually replace our "fortress Australian" attitudes in financial markets with a more vigorous, market oriented, outward looking stance.

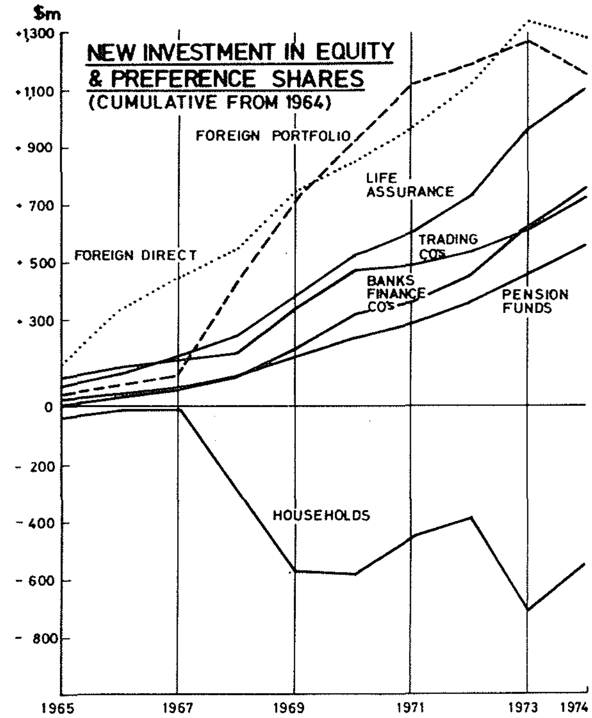
5. Above all, we must develop an ability to reach that vast bulk of Australian savers known to the Statistician as "the householder". Whether this can be economically done direct, or whether it must be done through institutions set up to handle smaller funds, is a problem for the experts. What we must not do is assume past methods are best. We must not shy away from the T.V. as the most logical way to communicate with those householders.

6. Finally, we must not fail to consider new forms of securities — if we can't beat inflation, should we not look again at Government securities with a low nominal rate of interest but whose capital value is indexed to retain its real value?

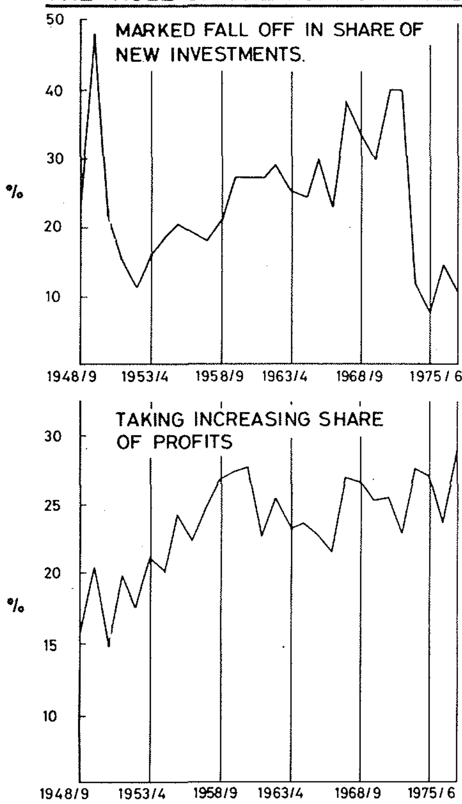


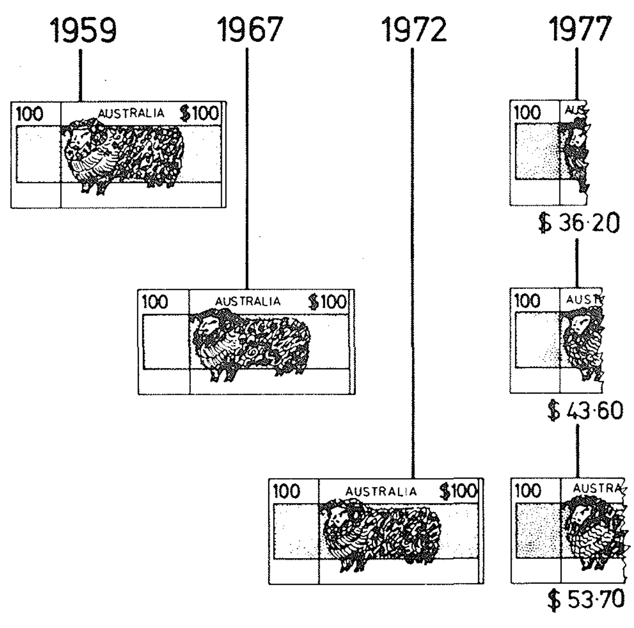






THE ROLE OF THE FOREIGN INVESTOR





HOW THE INVESTOR IN "RISK-FREE" BONDS FARED