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Inquiry into the international financial market effects on government policy

ASFA comments for the hearing to be held on 22 March 2000

Terms of reference

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

ASFA is not in a position to comment generally on this aspect of the terms of reference given that the conduct of fiscal and monetary policies involves a range of issues beyond the area of responsibility of superannuation funds. However, Australia can best take advantage of the opportunities provided by globalisation and minimise the risks by running sound domestic economic and social policies. Potential volatility is largely linked to the extent of short and long term net indebtedness to overseas parties.

The higher the level of domestic savings the stronger the net position of Australia is. With significant levels of domestic savings it is possible to make use of foreign investment and associated expertise with the net foreign exposure tempered by the investment overseas by Australians.

Superannuation funds currently have around 19% of their assets invested overseas. This amounts to some $76.7 billion out of a total of $415 billion as at September 1999. These overseas investments are made in order to obtain the benefits of a more diversified investment portfolio, and to maximise the investment returns available to the members of Australian superannuation funds. Australian investment opportunities make up only 1 or 2 per cent of the total world investment opportunities, and to limit investments to Australia only would unduly restrict the options available to investors.

Australia's engagement in the international economy is magnified by the range of transactions that occur in Australia's financial and foreign exchange markets. The level of turnover in foreign exchange markets far exceeds the level required to meet trade and capital movements. According to Reserve Bank figures, Australia ranks number nine in terms of foreign exchange turnover by market and number seven by currency. In contrast, Australia ranks only number 14 in terms of gross domestic product in the world.

This heavy turnover can assist in the efficient operation of Australian and overseas commodity and foreign exchange markets, but it can also be a potential source of instability of markets. Weakness in the value of the Australian dollar associated with developments in foreign exchange markets can leave the Australian economy susceptible to external shocks beyond the influence of domestic policy makers.

Levels of household savings are very low in Australia in historical terms. The 1999-2000 Budget Papers indicate that the household savings ratio declined to just over 1 percent in 1998-99 and was forecast to weaken even further in 1999-2000. The Treasury in Budget Statement No 2 argues that this is not a cause for concern given the strong increase in asset prices, particularly equities, in recent years. However, the capacity of households and the nation more generally to sustain repayment of Australia's international debt is linked to the value of Australian equities and other assets in terms of foreign currency. If the currency weakens and/or equity prices decline markedly, then this capacity would diminish substantially. The holding of foreign investments by superannuation funds and other Australian investors provides at least a partial hedge against such developments.

A higher level of domestic savings, in contrast to higher domestic asset prices and a subsequent increase in foreign borrowings, would place Australia in a stronger position to deal with any instability in the value of our currency and/or the willingness of overseas investors to place short term and long term funds in Australia. The relatively recent experience of a number of our Asian neighbours indicates the volatility of capital flows, and the pressure that can be placed on an economy when sentiment in international markets turns against a country or countries.

An increase in domestic savings also would assist in containing Australia's current account deficit. At over 5 per cent of GDP the current account deficit is at a level which means that Australia has to rely on continual and substantial capital inflow. This necessarily leads to a significant exposure to the vagaries of international financial markets. Higher levels of private savings in Australia through superannuation or other long term savings would reduce the current account deficit and reduce the risk being affected by international financial developments.

2. 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.

Disclosure requirements within the Australian financial system are designed to assist the stable and efficient operation of financial markets, and the protection of interests of retail investors.

Superannuation Circular No H.D.7 issued by the Insurance and Superannuation Commission in February 1997 governs the use of derivative transactions by superannuation funds. While superannuation funds are allowed. to create a charge over the assets of a fund in relation to a derivative transaction conducted on a recognised exchange, there are strict conditions attached to any such transactions.

For the transaction to be allowed the trustee of the superannuation fund must have prepared a Risk Management Statement in accordance with the requirements of the Circular. The RMS is a detailed document which sets out a wide range of controls, analysis and limits required when derivatives are used by superannuation funds. Use of derivatives must be consistent with the investment objectives of the fund, cannot be used for speculative purposes and can only be undertaken after analysis of market risk, liquidity risk, counterparty risk and operations risk has been completed.

In addition, trustees must report to members at the end of the reporting period if, at any time during the reporting period, the derivative charge ratio of the fund exceeds 5 per cent. The objectives of the regulator are that where funds use derivatives there should be in place appropriate policies for their use, adequate controls by the fund over their use, and adequate checks on compliance with those controls.

These very stringent controls mean that there is very little risk of any threat to the stability of the Australian financial system coming from the exposure of superannuation funds to the operation of derivatives. Prudential controls that apply more generally to financial market participants in Australia and to deposit taking institutions in particular also mean that in general financial institutions can cope with developments in currency and other international finance and commodity markets. Prudential controls are designed to prevent deposit taking institutions from having a level of risk exposure to markets or individual borrowers which could give rise to systemic instability in Australian financial markets in the case of adverse market developments or the financial collapse of a major borrower.

However, as indicated in a number of submissions, problems that have arisen in international financial markets have often been related to poorly supervised financial institutions in certain countries lending money to borrowers with only a limited capacity to repay such funds. If banking and deposit taking systems foster domestic instability, then it is not surprising that international speculative forces are given scope to operate.

Australia's best defence to instability in international financial markets is to have a well managed domestic economy, and an efficient and well supervised domestic financial system. Superannuation funds are important players in such a financial system.

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

Developments in international financial markets over the last year or two show both the susceptibility and durability of international financial markets. Those Asian countries with a sounder economic and financial framework or a willingness to take corrective action were able to weather the storm of international financial market developments with relatively few long term costs or problems.

The implication for Australia is that the higher the level of domestic savings and the lower our reliance on capital inflows from abroad the better placed is Australia to cope with international financial market developments. The recent history indicates that no individual country can insulate itself from international developments in financial markets, regardless of whether developments are soundly based or not. International capital flows have become stronger than the capacity of any country or group of countries to counter in the short term.

The avoidance of disturbances in the short term and the achievement of market corrections in the longer term is dependent on sound domestic economic and financial policies. ASFA would not support the imposition of controls on capital inflows or outflows can the effects that this would have on available investment opportunities and the efficient operation of capital markets.

"Export" of the type of prudential controls operating in the Australian financial system to other countries, particularly those with a history of poor or no prudential controls, would assist in achieving greater stability in international financial markets. However, it is likely that potential sources of instability will remain, given that speculative funds are likely to be attracted to those jurisdictions where controls are very limited or non-existent. International co-operation will help minimise such problems, but equally too harsh restrictions on international financial markets would be likely to have greater efficiency costs that any potential costs related to market instability from speculative activities.