"CHANGES AND CHALLENGES IN THE CAPITAL MARKET"

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The three papers as presented by Dr. Malcolm Hill, Mr. Barry Hefron and Mr. David Livingstone are included in this issue for the benefit of members of the Institute.

CAPITAL FORMATION – THE SHIFTING SCENE

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There is a story of a trainee priest who had to give a three minute sermon. He chose as his subject “God, Man and the Universe—Past, Present and Future”. He must have faced the same problems of selection as we have for this seminar today. Perhaps the main difference was that his congregation had a fair idea of what he would be talking about; our subject leaves more scope for different interpretations.

The capital markets are concerned with the borrowing and lending of money and with trading in financial assets. By mobilising and allocating the country’s savings and by facilitating trading they perform an essential role in the whole process of capital formation, thereby contributing to economic efficiency and growth.

Not all the funds for capital formation go through the capital markets. For instance, business and household savings and taxes are used directly to finance capital spending. On the other hand, the capital markets are not only concerned with borrowing money from the savers and making it available to the spenders. Often there is a “layering” of financial claims which means that between the saver and spender there might be several types of financial institutions. And an important role of markets is to facilitate portfolio adjustments between different types of financial assets and different maturities.

In talking about the shifting scene in capital formation I am going to pick out a few aspects which seem to me important. The graphs on the sheet are mildly relevant; it also gives you something to write on.

International comparisons are hazardous but there is no doubt that capital formation in Australia is relatively high; about 25% of our gross domestic product is reinvested in capital assets — factories, machines, houses, schools, roads and all the rest. In the National Income and Expenditure paper with the Budget we have a “National Capital Account”. For 1976/77 it shows gross fixed capital expenditure of over $19b of which $7b was by governments or public enterprises and $12b was private. The $12b was made up of $4b on dwellings, $2b on other building and construction and $6b on plant and equipment and all the other items. With an increase of $1b in private stocks there was a total of $20b to be financed. Of this, $10b was covered by the savings of households and unincorporated businesses, $6b by company savings in depreciation allowances and undistributed income, $3b in the gov-
ernment surplus on current transactions and depreciation, and $1b from overseas.

I am not going to bore you with information for previous years but if we compare the latest figures with those for the sixties or early seventies four changes stand out, some of them no doubt more temporary than others and all related:

1. The increase in the Government deficit.
2. The growth in the household surplus.
3. The decline in foreign investment.
4. Inflation.

I propose to say a little about each.

The Government deficit

Through the 1960's and early 1970's the Commonwealth Government ran deficits which might have sometimes looked large but in retrospect look quite small. The mid 1970's brought a dramatic change; we can see this in Graph 1. The recorded deficit increased from $300m in 1973/74 to $2.6b in 1974/75 and $3.6b in 1975/76. It has fallen since then but the Budget estimate for the current year is still for a deficit of $2.2b. One can make various adjustments to make the figures more directly comparable between years but the fact remains that for several years there has been a very large deficit to be financed. The same is true of other public authorities. There are limits on the extent to which State Governments and semi and local authorities can run deficits but over the last couple of years their spending has increased a good deal faster than their revenue. In fact the combined deficit for the whole public sector has recently been running at around $4b a year and it looks like going a good deal higher this year.

The financing of these deficits involves the placing of a lot of government paper through the markets. At June 1974 non-official holdings of Commonwealth Government securities were about $10b. Three years later they were $14 1/2b so in total an extra $4 1/2b of Commonwealth Government paper had been put out into the community. At the same time semi and local government authorities were putting out close to $1b a year. These figures are all very much greater than in previous periods.

What the future holds in this respect is uncertain but we can be sure that the public sector will continue to make very heavy demands on the domestic capital markets. And in large part these demands are met, directly or indirectly, from household savings.

Household savings

The household savings graph needs no explanation. If we drew a line through the 1960's the ratio would be something like 8 1/2%. In 1974/75 it was 18% and although it has come down since then it was still 14% last year. It is interesting that in 1950/51 it was even higher, but that was the year when woolgrowers had so much income that they couldn't possibly spend it all.

I haven't time to speculate on why household savings have gone up except to say that inflation and unemployment seem to encourage caution in spending. There are also lags between changes in income and changes in spending and there have been some structural changes in relative earnings. Rod Carnegie had something to say about this in an address last week to the Australian Industries Development Association. Consequences for capital markets include the flood of small savings into savings banks, building societies, credit unions and other repositories. Most of these are constrained by institutional arrangements or longstanding practice in their investments and tend to not be providers of risk capital.

Foreign investment

Australia has traditionally relied on foreign capital to supplement domestic savings. There have been periods of very heavy Government borrowing abroad but since the war the big inflow has been of private capital, especially risk capital. This has enabled us to run a consistent deficit in our current balance of payments and to undertake a heavy investment programme.

The fourth graph puts this into perspective. Through the 1950's and 1960's the current account deficit averaged nearly 3% of our gross domestic product and net private capital inflow was of the same order. This meant we were supplementing the resources
available to the Australian economy by about 3% which was financing something like 10% of our investment spending. For the last five years private capital inflow has been quite small in relation to previous periods — on average less than 1% of GDP which is little more than undistributed income from earlier investment. In other words, the small amount of new foreign investment has been roughly offset by withdrawal of capital and by Australian investment overseas.

One can think of reasons for this. Again I am saved by the time constraint, but in passing we can note what has happened to profits from Graph 3. The ratio through the 1960's was around 14%. In 1974/75 and 1975/76 it was down to 11% and last year was about 12%. But there have been other factors too which have been discouraging.

I am not going to make a prediction about capital inflow, but I wonder whether even when profits and activity are looking better we will get back to those heady inflow figures of the 1960's. If we are going to have relatively less overseas capital there are obvious implications for domestic capital markets.

Then there is the separate matter of variations in private capital inflow, which have been a major factor in movements in our overall balance of payments and so in the growth of the money supply and in financial conditions generally. Which seems to lead me on to the last of my four changes.

Inflation

The last two graphs are relevant. One shows that over 15 years average weekly earnings have increased fourfold and the CPI two and a half times. The big increases of course have been since 1972/73 — 17% a year for earnings and 15% for prices. The last graph shows very simply the consequences for interest rates. In the 1960's the long bond rate was around 5%; in recent years it has been around 10%.

Inflation has a direct impact on capital formation affecting both the supply of funds and the demand for them. In the more moderate inflation of the 1960's investors tended to redirect their funds in ways which they thought would provide a hedge against inflation — first into equities and then into real estate. The smaller investors now seem to be disillusioned and, despite the more rapid inflation of recent years, are keeping their money in highly liquid form.

On the demand side many factors work to reduce capital spending and change its composition. Changing patterns of demand, high and rising wage, interest and other costs, lower profits, higher taxes, excess capacity, uncertainties about Government policies and what lies ahead generally, all work together against the investment of funds in projects which take time to bring to fruition and whose profitability depends on continuing markets for their products.

Financial institutions are adversely affected by inflation and the efficiency of capital markets is weakened. No-one will lend long except at very high rates and no-one wants to borrow at those rates. The allocation of resources is distorted and the distribution of income and wealth is changed in arbitrary ways, often with harsh effects upon the weaker sections of the community.

Inflation is fed by too much money and this is the thread which links the varying aspects of the shifting scene which I have talked about. The public deficit and its financing, the level and disposition of household savings, capital inflow and inflation are all inter-related and all have profound implications for capital markets. Mr. Hefron and Mr. Livingstone will talk about some of them.
"Changes and Challenges in the Capital Market" — Capital Formation — The Shifting Scene

**GRAPH 1**
PUBLIC SECTOR DEFICIT

**GRAPH 2**
HOUSEHOLD SAVING RATIO

**GRAPH 3**
PROFITS RATIO
GROSS OPERATING SURPLUS OF COMPANIES / GDP

**GRAPH 4**
BALANCE OF PAYMENTS
AS PERCENTAGE OF GDP

**GRAPH 5**
PRICES AND EARNINGS
UNDER BASE 1961/62 = 100

**GRAPH 6**
BOND YIELDS

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**CHARTS:**
- **Graph 1:** Public Sector Deficit over time.
- **Graph 2:** Household Saving Ratio over time.
- **Graph 3:** Profits Ratio (Gross Operating Surplus of Companies / GDP) over time.
- **Graph 4:** Balance of Payments as a percentage of GDP over time, showing private capital inflow and current account.
- **Graph 5:** Prices and Earnings, including average weekly earnings and consumer price index.
- **Graph 6:** Bond Yields, including 20-year bond and non-rebate rates.