Despite the sweeping deregulatory moves of the 1980s, the next 10 years will see even more remarkable changes in the world's financial and capital markets, including those in the Asia-Pacific region, leading to widespread integration of standards.

The idea of global markets is hardly new. Companies such as IBM and Coca-Cola have long sought to colonise the world with their products. Indeed, the rise of major international manufacturing and trading enterprises has been the main stimulus to the development of global capital markets. Similarly, cross-border capital flows have been occurring since the evolution of mercantile societies.

However, the idea of very large global capital markets and international intermediation is a relatively recent phenomenon — markets that in aggregate dwarf all but the largest domestic capital markets. For example, in 1987 the OECD estimated that the total borrowings and equity raisings on international capital markets exceeded $US 380 billion. By the end of 1987 the Bank of International Settlements calculated that total outstanding international bank claims — that is, all claims on non-residents plus foreign-currency claims on domestic residents — exceeded $US 5 trillion. In that year net international bank lending is estimated to have grown by $US 255 billion. These totals were probably unimaginable even a decade earlier.

In the context of globalisation, a number of existing trends are likely to continue into the 1990s, including:

- An increased blurring of the distinction between domestic and international capital markets. Purely local markets will continue to service purely local needs, but they will be increasingly influenced by global developments. The idea of domestic capital markets hermetically sealed against external influences is already dead, especially as far as countries such as Australia are concerned.
- A polarisation between global enterprises and small, local concerns. Large, independent local or regional corporations will decline in number and influence. Although many of the global enterprises will be marked by great size, some will be relatively small, selling highly specialised products or services on a global basis. Financial intermediaries will not be excluded from this trend.
- A further increase in the overall size of global capital markets. However, particular securities, instruments and sub-markets will wax and wane according to changes in the international environment and, I dare say, subject to the dictates of fashion.
- A continuing proliferation of derivative instruments and products. Many of these will be shooting stars, flying high and dying young. Some innovations will meet real needs, and will endure.

The only real threat to the globalisation scenario is a deep and prolonged international recession which forces market participants to shelter behind the security of national boundaries. Such security will almost certainly be illusory, as it was in the 1930s, although this is
Technology and the markets

Modern capital markets are very much the child of technological innovation. This fact has had at least four important consequences:

First, the development of modern data-processing and telecommunications technology has produced enormous improvements in price/performance capabilities. Each year we get far more return from our technological dollar. Contrary to the view of many, I believe technology is no barrier to the entry of new capital markets participants; it probably makes entry easier. The hardware and much of the software can be bought, and at less than prohibitive cost.

This is not to deny that those participants who manage their technology shrewdly and efficiently will gain competitive advantage. Moreover, evolving software capabilities, including so-called "artificial intelligence", may stimulate greater competitive differentiation.

Second, the instantaneous global transmission of news and information means that all markets, including predominantly domestic markets, are increasingly exposed to external influences. Likewise, technology gives market participants the ability to react to events very rapidly. This is an important factor in the increased volatility of capital markets.

Third, technology has done away logically with the need for a central, physical marketplace. People may prefer to do business face to face, but that is another issue. Similarly, the physical domicile of financial intermediaries and other corporations is becoming less important — one can operate effectively in many markets from quite exotic and out-of-the-way places.

Fourth, technology promises a solution to one of the bugbears of many markets: the lack of quick, reliable and secure settlement mechanisms. In Australia we have already experienced the improved efficiencies achieved by such systems as Austraclear and BITS. The questions of who should be allowed access to these settlement systems, and on what terms, are likely to be ongoing issues in the 1990s.

The nature of technological innovation is inherently unpredictable, as is the way we choose to exploit it. How, for example, will the truly portable, pocket-size telephone or fax machine change the way we do business? Without doubt it is the new communications technologies that will raise the most questions and opportunities about how we currently do business.

Regulation

The 1980s has been called the decade of deregulation in banking and financial markets, but that deregulation has been spotty, and there have been many instances of re-regulation.

In the United States, for example, the Glass-Steagall Act lives on, denying commercial banks the ability to underwrite and trade in certain securities, and the McFadden Act prohibition on interstate banking is only now being dismantled — and only partially.

In Japan, the deregulation of capital and financial markets appears painfully slow, at least to outsiders.

In the United Kingdom, the new financial services legislation is becoming a real headache for some market participants.

In Australia, at least at the State level, the consumer protection lobby has so far successfully, if misguidedly, resisted the reform and liberalisation of credit laws.

In many countries the immediate response to the October 1987 stockmarket crash was to call for the prohibition or regulation of certain practices that allegedly contributed to that debacle.

However, I believe the underlying trend is still in the direction of financial deregulation. Moreover, I suspect that the term "convergence" will become one of the buzzwords of the 1990s.

By convergence I mean the harmonisation between countries of regulatory practices involving financial and capital markets, and even the harmonisation of tax systems. That is, the regulatory practices of most economically advanced countries will tend to converge around common standards. We have already experienced an example of this process in the new capital adequacy standards for commercial banks.

And if the European Community is to achieve its unified financial services market from 1992, then a high degree of harmonisation of regulatory, tax and accounting systems between member countries will be an essential precondition.

Although convergence has a certain logic and symmetry to it, the real dynamic is the emergence of global capital markets and the increased mobility of financial intermediaries and other corporations to which I have already referred. In short, countries that engage in excessive or capricious regulation, that impose excessive and inequitable taxes, or that permit idiosyncratic accounting standards, will pay a high price in terms of capital flight and lost opportunities for their financial services sectors, and their economies generally.

Consider the growth of the less-regulated international financial centres. Such centres are already well-established in the Bahamas and Cayman Islands and we may see more growth in embryonic centres, such as Panama. Whether this trend will flourish, wither or endure on the fringe is hard to predict. Further global deregulation could diminish the relevance of these peripheral operators. Alternatively, further convergence of operating rules in the major countries — as we see in the capital adequacy standards — could constrain tendencies for operators to migrate from major financial centres.

Another opposite effect of regulation is the growth of non-banking financial institutions. This trend must produce major change. Either the non-banking operators will be compelled to play under the same rules as the banks, or more and more banking business will flow to the non-regulated areas. That process, of course, helped precipitate the

Asia-Pacific economies: real GDP growth (%)

<table>
<thead>
<tr>
<th>Country</th>
<th>1987</th>
<th>1988(+)</th>
<th>1989(+)</th>
</tr>
</thead>
<tbody>
<tr>
<td>South Korea</td>
<td>11.1</td>
<td>10.0-11.0</td>
<td>7.5-8.5</td>
</tr>
<tr>
<td>Singapore</td>
<td>9.0</td>
<td>7.0-9.0</td>
<td>5.5-6.5</td>
</tr>
<tr>
<td>Taiwan</td>
<td>11.0</td>
<td>7.0-8.0</td>
<td>6.0-7.0</td>
</tr>
<tr>
<td>Hong Kong</td>
<td>14.0</td>
<td>5.0-6.0</td>
<td>5.0</td>
</tr>
<tr>
<td>Malaysia</td>
<td>5.0</td>
<td>7.0-7.5</td>
<td>5.0-6.0</td>
</tr>
<tr>
<td>Indonesia</td>
<td>4.0</td>
<td>5.0</td>
<td>5.0</td>
</tr>
<tr>
<td>Philippines</td>
<td>5.1</td>
<td>6.7</td>
<td>6.0</td>
</tr>
<tr>
<td>China</td>
<td>9.5</td>
<td>7.5-8.5</td>
<td>7.0-8.0</td>
</tr>
<tr>
<td>Thailand</td>
<td>7.0</td>
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<tr>
<td>Japan</td>
<td>4.2</td>
<td>3.5-4.5</td>
<td>2.5-3.5</td>
</tr>
</tbody>
</table>
Great Australian Deregulation early in the 1980s.

The non-bank financial institutions are well established in Australia. But in other countries, particularly the United States, the growth has been even more vigorous and widespread — watched with growing frustration by a highly regulated commercial banking industry.

How many realise that, in 1988, Ford Motor Credit Company lent more money than any American bank? Or that Sears, a firm of shopkeepers, has more banking outlets across America than any bank? For the K-Mart network, the same is true. These are banks in every sense, but because they do not call themselves banks they can operate outside the supervision of the Federal Reserve Board.

The same process will occur here if regulation becomes too onerous. Regulate banks and you drive activity outside the system. Consider the activities of pension funds, insurance companies and superannuation funds. These are regarded as our biggest investors. But to my mind they are also banks. When they buy corporate bonds, promissory notes and bills of exchange, are they not lending money? If governments will not let the marketplace resolve the operating anomalies, the problem must be addressed by the bureaucratic regulators and their political masters.

Accounting standards

At present there are significant differences in accounting standards and methodologies between countries. The financial statements of a corporation can look quite different depending on whether the accounts are prepared according to, say, Australian, American or British accounting principles. It remains a puzzle to a non-accountant how the one underlying reality can be measured and described in so many different and apparently legitimate ways.

Indeed, in extreme cases, a substantial profit can become a substantial loss depending on the accounting standards employed.

The bewildering complexity of many corporate structures is an added complicating factor.

To my mind, the international convergence of accounting and disclosure standards cannot come too quickly. I am aware that the International Federation of Accountants and the International Accounting Standards Committee have done much good work in issuing international accounting and auditing standards, but the take-up of these standards has been disappointing. I am equally aware that among accounting professionals and in the wider business community there are genuine differences about how certain matters are best treated in an accounting sense. Nor is there any benefit from uniformity if the standards developed are not themselves soundly based.

Nevertheless, if the function of capital markets is to allocate and price capital according to the productivity, efficiency and financial integrity of competing users, then some consistency in the way we measure these characteristics is essential. Clearly, changes must come into the accountancy practices so that balance sheets will reflect the real value of non-tangible assets. It will not be easy to achieve this, but present practices cannot be allowed to continue.

Take the case of brand names. A brand name may be worth a great deal. Much money and effort may have gone into establishing it. But that value may not appear on the balance sheet because accountants list only physical assets. So people who rely on balance sheets to establish the worth of shares often get an undervalued perception.

But the takeover specialists are not deceived by balance sheets. A common target is a company undervalued by the balance sheet. Today, we are measuring the wrong things on the balance sheet.
We are not measuring shareholders wealth; we are measuring things that the accountants conventionally value and count. This means the accountants are giving false impressions to some people.

**Cross-border investment**

Direct cross-border investment and lending is not a new phenomenon. Nor, that is, in the sense of building a factory, opening a mine, or starting a business in another country. Banks and other intermediaries have for generations lent and borrowed across national boundaries and in and out of different currencies.

What is relatively new, at least on a very large scale, is cross-border, portfolio-type investment. Today more individuals than ever in the past have at least a portion of their savings invested in securities purchased in another country and probably denominated in another currency. They may not even be aware of their offshore investments, these securities having been purchased by their superannuation fund, life office or other investment manager.

Add this element to the more traditional activities of the major financial institutions, and we find an increase in both the volume and velocity of funds movement in capital markets. The reasons for this development include:

- The relaxation of restrictions, such as exchange control, on legitimate cross-border capital movements.
- Improved communications allowing investors and fund managers in, say, Australia, to obtain accurate, up-to-the-minute information about investments in, say, North America or Europe. At least for the professionals, the physical act of buying or selling has become simpler and quicker.
- The need of major investment institutions in many smaller countries to find suitable outlets for the accumulating investment funds. In Australia, for example, big investors such as the major life groups and superannuation funds are finding it increasingly difficult to satisfactorily place all of their funds in the domestic market.
- Competition between investment managers to improve returns, which has made offshore securities and markets more appealing, at the same time providing a wider spread of risk.
- The development of new instruments and techniques to assist in managing the risks associated with cross-border investment.
- International trade imbalances and floating exchange rates which encourage cross-border capital movements by making, for example, physical and financial assets in Australia or the United States look comparatively cheap to, say, Japanese investors.

The result of these developments is to increase the volatility of capital markets, which is something we will have to learn to live with in the 1990s.

Finally, a few specific remarks on the evolution of capital markets in the Asia-Pacific region.

I have heard the Japanese described as the Arabs of the 1980s, this being a way of comparing Japan's immense trade surpluses with those of the OPEC countries in the Seventies. The difference, of course, is that unlike most of the oil-rich countries, Japan has the financial institutions and a level of commercial sophistication that will allow its capital surpluses to be reinvested in a way that should benefit most of us.

And, in any event, as the 1990s progress there are good reasons for believing that Japan's capital surplus will diminish. This will be the result of the interaction of external and domestic influences. Meanwhile, however, we can expect the major Japanese banks and securities houses to further increase their penetration of international capital markets, although at the same time Japan's domestic capital market is likely to become less regulated and more sensitive to external forces.

In the region's other growth economies — and I would put Thailand and perhaps Indonesia on this list — the increased sophistication of the industrial and commercial sectors must inevitably lead to a liberalisation and opening-up of the financial sector.

Within Australia, I suspect that the first part of the 1990s will be a period of consolidation in domestic capital markets. We are still digesting the big changes of the early and mid-eighties, and there is little doubt we still have too many participants for the available business.

That will change. Those of us who are left will be better at what we do, and the markets themselves will be deeper and more liquid.

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**A GLOBAL SEARCH FOR THE PERFECT HEDGE**

The entire history of financial futures spans just 16 years. Options trading is an even more recent phenomenon. The technological revolution that has allowed trading systems to evolve toward greater automation has also spurred the development of new instruments. This trend will not abate; it will persist over the next 10 years.

As our ability to analyse the pricing and risk characteristics of instruments has improved, the financial community has been quick to develop specialised products to meet the demands of diverse customers. Currency futures, which are traditional contracts applied to non-traditional commodities, were quickly followed by interest-rate and stock-index products. While innovative, these standardised instruments are merely the foundation for a vast array of off-exchange instruments including repurchase agreements, caps, collars and the like.

We can expect that lines between the exchange and off-exchange instruments will continue to blur. Professional traders will be able to choose from a vast array of instruments — some general and standardised, some customised to the user's needs. Hence, financial integrity — the ability of exchanges to provide guarantees in the clearing process — will more than ever be the pivotal difference. Traders will continue to rely on the exchanges for liquidity and the security that cannot be replicated in off-exchange markets.

Existing regulatory distinctions between exchange and off-exchange trading will become increasingly artificial as the products converge. It will be vitally important for regulators in each country to recognise the similar nature of these instruments, and to make sure that regulatory inconsistencies do not create artificial competitive inequities between them. Marketplaces cannot be protected through regulation. The business will go to the cheapest and best market.

But don't expect that this will be an

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KEITH PHILLIPS: QUIET CONTRIBUTOR

Keith Phillips, who died in April, will be remembered by his peers as a quiet, retiring man who made a solid contribution to the growth and development of Australia's financial markets. Educated at Sydney Grammar School and the University of Sydney, Mr Phillips joined the Sydney-based sharebroking firm Ralph King and Yuill as a clerk in 1935, after graduating with an economics degree.

The war, army service and a three-year stint in China with the United Nations Relief and Rehabilitation Administration interrupted his career and it was 1948 before he returned to sharebroking and a partnership with Ralph King and Yuill, a position he held until his retirement in 1975.

During those years he not only contributed to the expansion of that pedigree firm but also played a role, with a number of others in the late 1950s, in pushing for the establishment of the official short-term money market. A number of sharebroking firms had been running a “buy-back” market in government securities, taking short-term deposits from clients and in exchange selling them government securities. This practice of borrowing clients’ funds and securing them with bonds sowed the seeds of the official market.

The official market was born in 1959 when the governor of the central bank, as the Reserve Bank did not begin formally operating until 1960) announced the establishment of four dealer companies. A further five companies were accredited dealers in 1960. Ralph King and Yuill’s “authorised” dealer arm, Short Term Acceptances Ltd, was in the first batch. Keith Phillips was an executive director of the company.

Earlier in his career, before the war and his service in the Australian Army, Keith Phillips had spent a year in London, gaining experience with the firm R. Layton and Company. Building on this earlier association, he was able to establish significant London-sourced business for Ralph King and Yuill.

Mr Phillips is remembered as someone who gave considerably of his own time to the industry, through his long service on the Stock Exchange Committee, from 1965 until 1974, and

on a number of sub-committees. He was also a keen supporter of the Securities Institute, becoming an associate member in 1966 and being elected to fellowship of the Institute in 1969. He served on the Federal Council from 1966 to 1969 and then as Vice-President until 1973. He was also President of the NSW Division Council for a number of years.

Friends and peers remember Keith Phillips as a shy man who was good company, with an agile, analytical brain. It was not his nature to push himself forward; he listened more than he spoke, but when he did say something it made sense. Many of today’s leading share-market operators appreciate the guidance he gave them in their earlier years.

Mr Phillips was an active sportsman, with interests including yachting, golf and skiing. He travelled extensively.

He is survived by his widow, three daughters and a son.  __ Edna Carew

SEARCH FOR THE PERFECT HEDGE

From Page 5

era for deregulation. While the crash of 1987 did not generate any evidence to suggest that regulatory gaps exist, memories of the crash are too fresh. These memories will undoubtedly stymie any serious attempt at deregulation.

Globally, products that once appealed to customers in only one or two nations now have a worldwide audience. Global diversification and integration has just begun, and in 10 years there will be very few markets of any significance that are pure single-country markets. The shift to global portfolios is an expression of a desire to diversify risk more completely than is possible with a single-country portfolio.

John Phelan, chairman of the New York Stock Exchange, compares the global quest for the right hedge to the “surfer who travels the world looking for the perfect wave”. Phelan recently told the Financial Times that investors will continue to “go around the globe looking for the perfect hedge”. And no wonder.

Finance theory tells us that by expanding the number of instruments, the average volatility of a portfolio can be reduced without lowering the average return. Shifting values of foreign assets and the various exchange rates all imply risk, but with smooth flows on capital these features can also mean tremendous opportunity for more efficient risk management through diversification.

Regulatory issues also transcend national borders. We are just beginning to appreciate the impact that differential regulation can have on a national market. Some have argued that the globalisation of the markets is a response to the liberalisation of regulations concerning options and futures. I would argue the reverse. Because capital is flowing across national boundaries more freely and efficiently than ever, any market that is constrained by unnecessary regulation is at a tremendous competitive disadvantage. The liberalisation of market regulations that is occurring in Germany is a response to demands by German traders who are saying: “We cannot and will not be left behind”. They know all too well that Europe is in the midst of a revolutionary expansion and that “Europe 1992” is just around the corner.

Liberalisation has also occurred in the US. For example, when the Sydney Futures Exchange recently petitioned the US CFTC for an exemption from certain registration requirements, arguing that Australian and American listing requirements are already quite similar, the exemption was granted. Now, the Sydney Futures Exchange has become the first overseas exchange with full access to the Chicago markets.

When competitive pressures build, regulations must be eased. During the next 10 years, we will see an increasing homogeneity of market regulation across national boundaries. Regulation will be sufficient to protect customers, but markets will not likely be burdened with costly extra regulation that would serve only to drive business elsewhere.  □