CHECK AGAINST DELIVERY

Alex Erskine speech for China Financial Summit, 17 May 2018

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[SLIDE 1]

Thank you for this invitation to address important people about some important issues. Hopefully, as a result, I will contribute to your efforts to make advance financial and economic development in China and Asia, and in Australia. There is potential for much more economic and financial integration in this region, which I fear may never be achieved unless governments, regulators and the finance and corporate sectors become more ambitious and more effective at driving progress.

Introduction

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My talk is also an opportunity to reflect. I was asked to serve in a rare position – chief economist for Australia's securities and investments regulator, ASIC, commencing in 2007 and finishing in 2013. I was fortunate to be part of ASIC's management team though a testing time in our economic and financial history. There were many regulatory challenges. We all learned a lot from the Global Financial Crisis (GFC) and how financiers and others behave under stress.

You will see from my bio that I seem to have made a habit of being around when financial crises occur, with Citibank in Australia for Australia's last recession – now more than 25 years ago – and in Asia 20 years ago for the Asian Financial Crisis. Earlier roles had been putting policies in place to avoid crises in future: so far, evidently, we have not been very successful.

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As you no doubt recognise, there is a constant tension in finance. In practice we know there are persistent economic cycles and – more occasionally – financial crises, despite the very fine theories (the Efficient Markets Hypothesis and Rational Expectations theories) whose implications are that financial crises should not occur.

This matters because these theories, especially the Efficient Markets Hypothesis, are the foundation and rationale for much of securities markets regulation. As we will see, Market Integrity regulation seeks to create and maintain the conditions in which the Efficient Markets Hypothesis can work, at least in its semi-strong form.

When I was with ASIC, the securities regulator, one of the main tasks was to identify emerging risks for the Commission. It seemed to us that it was obvious that the very fine theories, the Efficient Markets Hypothesis and Rational Expectations, were not describing what was happening. EMH maintains that – so long as there is market integrity – everything we know about the future is already incorporated in the market price, and its adherents say that efficient and complete markets will allow and enable borrowers and investors to seamlessly shift their portfolios as prices on risk change, and so ensure financial stability.

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The theories were being overtaken by events. Two individuals with clear minds helped illuminate the path ahead. These were Hyman Minsky, who had sadly passed away in the 1990s, and Warren Buffett, as you know happily still very much alive.

Warren Buffett, the prominent value investor leading US firm Berkshire Hathaway, had said – with some of his usual humour – that "Only when the tide goes out do you discover who's been swimming naked". The economic and financial "tide" was clearly going out and would go out for a long time.

The late Hyman Minsky was even more help. His 1960s-1990s thinking on financial instability had been very much outside the mainstream of economic policy thinking – Minsky had been a maverick amongst US economists and bankers. But what he had anticipated describes the GFC perfectly as it unfolded.

A long stretch of prosperity had sown the seeds of the crisis. Too much of the financing being undertaken had become "Ponzi financing", as Minsky would have called it, essentially borrowings for investments that lacked cashflows, so they could only be serviced and repaid if asset prices rose for ever more. Not enough financing was normal and safe, to be serviced and repaid from regular cashflows, or only even speculative, with cashflows but with borrowers expecting to roll over debt rather than repay it at maturity.

With Minsky-style Ponzi financing dominating US and European debt and equity markets in the 2000s, the GFC became inevitable.

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Despite this insight on the sort of bad events that lay ahead, the securities regulators such as ASIC still had to pursue market integrity. In fact in difficult times, as the "tide goes out", to use Warren Buffett's description, bad people commit more financial crimes. There was potential for more market abuse, more insider trading, more market manipulation, more front running. It became increasingly important to ensure information on prices and issuers of securities were made available to all participants at the same time, rather than leaked to a few privileged participants before others who were less-connected. The securities regulators, like ASIC, thus had to become even more vigilant and active, in order to maintain market integrity even while the crisis unfolded.

Let us turn now to our main topics. I assure you the background I have set out is relevant to the topics.

I have been asked to talk about three topics, all relevant to this audience and to China:

1. Integration and Development of the Capital Stock Market;
2. Interpretation of the Economic Environment; and
3. Australia's policy on stock market listings.

[SLIDE 5]

Today'[s first topic is **Integration and Development of the Capital Stock Market**

Development of deep markets for debt and equity issues has been a vital aspect of economic and financial development of the economies currently described as "advanced economies". Development of banks and the formation of sound banking systems has been a rival vital aspect of successful economic development. The complex circumstances of each country have an influence of which leads or lags.

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Most focus has been on the markets as places for capital raising or for investment, but key attribute of good markets is that they also continuously price risks and continuously provide opportunities to diversify risky bets. In a sense it is a win-win situation: bigger markets with more turnover and new issues breed more opportunities. But there is a major implication as financial markets become more important: the markets need ever-sharper policies to improve and maintain market integrity.

With cross-border trade and investment a characteristic of the pattern of development of the world, the market places for debt and equity issues has similarly become cross-border. And regulation has gradually become less insular, more cross-border.

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What I want you to focus on, however, is how integration between capital markets, financial sectors and financial systems has not gone very far, especially in Asia-Pacific.

Despite the business sector's embrace of global opportunities, the extent of development of the global market place for debt and equity is still low, held back by individual countries' policies, regulations and behaviours.

There has also be less integration of capital markets across borders than might have been expected. Only in the big common-currency areas such as the USA and Europe have capital markets significantly integrated. With no prospect of development of a United States of Asia or an Asian Union to mimic the USA or the EU, Asian capital markets will remain substantially unintegrated and will continue to dance to the tune from the US and EU.

The efforts to speed up integration in the Asia Pacific region have been weak so far. The long negotiations of the trade agreements for the Trans Pacific Partnership (TTP), which excluded China but included the USA, were set back by US withdrawal, and the even longer-drawn-out negotiations for the Regional Comprehensive Economic Partnership (RCEP), which includes China but excludes the USA, have been unambitious on opening up opportunities for capital and financial market integration.

Meanwhile every day we read of threatened or actual protectionist trade policies, to "throw sand" into the wheels of trade, with trade barriers and trade wars. You can guess as easily as I how this could be very detrimental to the world economy and welfare.

But we have not reached that stage – threats of war - yet with finance, simply because so little financial integration has been achieved yet. At this stage, Asia-Pacific investors, institutional or household, still display strong "home bias", forgoing the benefits that could be gained from greater geographic diversification.

The targeted stock market and funds management initiatives such as the HK Shanghai link, the ASEAN Collective Investment Scheme (CIS) and the Asia Region Funds Passport scheme (ARFP) represent baby steps so far.

However, if governments and regulators fail to increase the pace of cooperation and to encourage a faster pace of integration, then it will fall to individual investors and companies to make it happen. Individual investors can access – and perhaps are beginning to access – the now-old innovation of Exchange Traded Funds (ETFs). These represent an inexpensive way to get exposure to a collective of shares of companies in different foreign countries. And – as we will see later in this talk – individual

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companies can apply to list on foreign stock exchanges, to gain access to international capital and international regulations.

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Our second topic today is my **Interpretation of the Economic Environment**

Since the GFC the advanced countries have pursued extraordinarily easy – stimulative – monetary policies, to revive economic demand and activity. Generally, this has been a success – only in a few countries have unemployment rates been as high as in the 1930s Great Depression. The principal focus of all investors has been a search for yield. This has seen much more risk-taking amongst usually cautious institutional investors, into lower-tier investment grades.

Now we have reached the stage in long-drawn-out period of stabilisation after the shock of the GFC where the very low levels of interest rates necessary to avoid further crisis-driven collapses are no longer necessary. With advanced-country central banks targeting low positive rates of inflation, the market is focusing on interest rate rises. Bond yields are backing up.

You can tell this is the time. The speculative fervour for Bitcoin and other cryptocurrencies are symptomatic of the inevitable end of the era, the last phase of the expansion cycle. But it can also be seen in the gradual lowering of conditions on debt issues, just ask the ratings agencies.

Australia comes into the equation here.

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Australia was lucky in the GFC but had earned that luck. For more than a decade, Australian governments had pursued very robust medium-term policies (with 5 mutually-reinforcing aims: low inflation, budget balance and market-determined exchange rate, sound prudential standards and market integrity). These have supported and encouraged businesses to take their own risks. So Australia's starting point for the GFC and the recovery period was quite favourable.

The government made good and swift decisions on financial system regulation when the GFC emerged and global markets closed (thankfully only a temporary closure): government guaranteed the banks' liabilities and protected bank depositors by making the government's implicit support for deposits into an explicit guarantee.

With low interest rates, reasonable global – including Chinese – demand for Australia's exports and overall sensible fiscal policy, Australian economy has continued to fare well.

Of course, policy and regulation could not then just stand still. There have been significant efforts to improve prudential regulation and market integrity.

But now two bigger challenges loom, and it will be fascinating to see how they work out.

The first is that house prices have risen for many years across Australia, but especially in the big cities of Sydney and Melbourne, on the back of financing that Hyman Minsky would call very risky. Interest rate rises and interruptions in the ready availability of new debt to roll over old debt could cause a significant problem, not only for borrowers but also for the banks. Their capital buffers have been strengthened, but it will be interesting to see what occurs in real life rather than in stress test games.

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The second is the trust-destroying behaviours of many of our bigger financial institutions that are now subject to a very public Royal Commission inquiry. So far this has not led to significant flows of funds out of particular institutions or from the financial system as a whole, or any questioning of the safety of deposits, but we must be wary.

It is in that context that Australians worry that the “trade war” being waged by the US against China may disrupt our banks’ smooth and constant access to international finance or erode confidence in our banks. As a result, many in Australia are quietly very alert, hungry for international news, and easily alarmed!

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So now to the third and final topic. **Australia’s policies on stock market listings**

As I said earlier, companies listing on foreign exchanges, such as Chinese companies listing in Australia, is a practical way to achieve access to international capital, spread knowledge and understanding and along the way promote financial integration.

However, it is true that Australia’s requirements for foreign issuers seeking a listing on the Australian stock market have been tightening. The recent boom in Chinese companies listing in Australia, which got under way in 2014, seems to be over.

Some potential listers – the Chinese private companies that had been attracted to some advantages of listing but had not yet succeeded in doing so – may bemoan the fading opportunity. Similarly, many of the investors will bemoan their decisions to commit capital to share issues over the recent years. Almost all have seen poor liquidity and falls in share prices (a personal declaration of interest: I have invested in at least one Chinese issuer on the Australian market).

Unsurprisingly the exchange and the regulator have been tightening up requirements for listing and for behaviours after listing, and the result will be an improvement in market integrity and in the quality of listings and company behaviours in future.

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Australia is an attractive market for some foreign companies to list and seek capital from. Over many decades, there have been sensible economic and financial policies, as well as – even with current challenges – sound prudential policies and reasonable market integrity. The superannuation pool of funds – which is what we in Australia call our pool of retirement savings – is by now quite large, at A$2.5 trillion, and is set to rise for several decades yet. The market capitalisation of the ASX, the listed companies on Australia’s main stock exchange, is just under A$2billion. There are over 2000 domestic companies listed, and 137 foreign-origin companies. China is the origin of the largest number of the foreign companies that are listed.

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The rules for the listing of <u>Foreign Incorporated Companies</u> are readily available from the Australian Securities Exchange (ASX). They include an option, to apply:

- under a so-called profits rule, or
- under a so-called assets test.

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The assets test is more suitable for companies that do not have a sufficient track record as a viable business.

No matter which test is chosen, the applicant must achieve a minimum “free float” of 20% or more of its shares, and a “spread test” of at least 300 non-affiliated security holders with shares worth A$2,000 (or more).

There is a different set of requirements for larger more established companies, under the Foreign Exempt Listing rules.

No matter which route you or your clients wish to take, do get your own professional specific advice. There are Australians here in Beijing, such as James Huey of China Westbridge Advisory Services, who may be able to help.

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Of course, in achieving your listing and maintaining that listing thereafter, there are significant on-going market integrity obligations, especially around continuous disclosure. These obligations are spelled out in the Listing Rules and Guidance Notes of the exchange, the ASX, and in the laws and guidance provided by the Australian Securities and Investments Commission, ASIC. Here I have highlighted an ASIC report, so-called RG521 Further Review of Emerging Market Issuers, published a year ago – in April 2017. It in turn was building on many concerns about the impact of emerging market issuers on Australia’s market integrity (see RG368 Emerging market issuers August 2013). ASIC is bound to persist with its focus on market integrity.

I don’t believe setting out these concerns is in any way an expression of anti-China sentiment. Australia does want foreign companies to list. The quest for rising standards for issuers applies to all, foreign and domestic. If I were a potential Chinese issuer seeking listing on ASX, I would want to be the best issuer I could be.

I recall my years working for Citibank, now Citi or Citigroup. Citi hired the best people in every market, drawing on the top % of each population. No wonder so many Chinese (and Indians) have risen to the top of Citi – the top % of a population of 1 billion is an amazing talent pool. It will be the same with Chinese issuers in more developed markets like Australia: if the top % of companies seek to list, the winners will be amazing.

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Thank you for being an attentive audience. I hope you are encouraged to promote and participate in international integration. I wish you the best in these interesting times. If there is scope for questions, I will be delighted to try to answer them.

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