Business Investment and Banks

Talk by the Governor, B.W.Fraser, to CEDA Annual General Meeting, Sydney, 24 November 1993.

This is my fifth appearance at a CEDA AGM dinner, and perhaps the regulars among you are beginning to feel the onset of fatigue. For my own part, I see no end of topics that could be discussed in this forum.

At past meetings I have talked about a variety of policy matters, with a particular focus on monetary policy – inflation and other objectives, independence of the Reserve Bank and all that.

Last year, teeing off CEDA's commendable efforts to define a vision for Australia, I talked about aspects of longer-term economic growth. I noted the obvious point that government policy is itself an important factor of production in the growth process.

I suggested also that perhaps it was time, being almost 50 years since publication of the celebrated 'White Paper on Full Employment in Australia', to have a similar paper on growth and related issues. That suggestion was not picked up, although the Government is working towards a White Paper on unemployment, our major economic and social problem.

No one questions that government policies can have a mighty impact, for good or ill, on production and employment. Indeed, the value added (or subtracted) by government policies helps to explain why some countries perform better (or worse) than others. Other things are never equal but, if they were, the best performers would be countries with clear, certain and consistent economic policies.

Delivering such policies is easier said than done. A common complaint these days is that policy and its accompanying legislation in many areas – taxation, superannuation and Mabo to name three – are excessively complex and confusing. Perhaps part of the confusion is manufactured, out of either deliberate intent or negligent ignorance. I suspect the larger part, however, is inherent in the very process of trying to deliver the clarity and certainty in legislation that everyone clamours for – the harder governments try to do this, the more complex the legislation is likely to be.

I do not see any real solution to this problem. An outbreak of enlightened national consensus building on major economic and social issues would help but the prospects for that, unfortunately, look forlorn. Governments could, no doubt, help to reduce confusion, if not complexity, by trying harder to explain the intent and rationale of their policy changes. At the end of the day, however, some businesses (not always the same ones) will have to find their way through – or 'live with' – particular policies and pieces of legislation they might wish did not exist.

For businesses generally, the most critical requirement, in my view, is that there be reasonable certainty and consistency on the policy 'fundamentals'. I believe that has been the case in Australia, by and large, for some time now.

Macroeconomic policies have been consistently supportive of stronger economic and employment growth, while mindful of preserving the gains on inflation. We are now seeing results. Most indicators are suggesting a pick-up in what has been a modest rate of recovery, perhaps to about 3 per cent. Consumer spending – led by 'durables' – and housing investment have been important contributors to the recovery. These sectors have responded, albeit gradually, to the easings in monetary policy, which have seen short-term interest rates fall from 18 per cent to under 5 per cent since January 1990.

The other major contributor to the recovery has been government spending. This has increased in part as an automatic response to rising unemployment, and in part as a result of deliberate government spending decisions.

With the economy picking up, the scope for further major stimulation through monetary and fiscal policies is diminishing.

The same constraints do not apply to micro-economic policies. Over the past decade, many measures have been taken to free up labour and capital markets, to lower tariffs and to otherwise increase competition in the markets for goods and services. As a result of these and other changes, Australia's international competitiveness has improved by about one-third over the past decade.

But there is still further to travel.

As those who operate at the front line know, staying competitive means staying on the treadmill of reform. We like to see ourselves as part of Asia these days – and rightly so, given that 60 per cent of Australia's exports go to countries in the region. Holding our place in this company requires that we stay in touch with the rapid pace of change in many Asian countries. Indeed, these days we face fierce competition for investment not only from Asia, but also from 'emerging' countries in Latin America and even Eastern Europe.

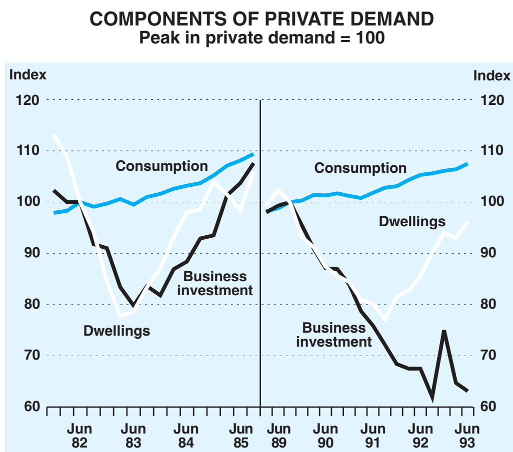
Government policies are obviously important but they are not the end of the story. Businesses and others have to be on the job too, seeking out and following up the opportunities flowing from our improved fundamentals. Nowhere is this more critical than in the case of business investment. Investments which earn a good return advance the prosperity of shareholders and citizens alike; as well as rewarding investors, they generate jobs and raise real wages.

Business Investment

So far in the present recovery, aggregate business investment has been a conspicuous 'missing link' (see Graph 1). The surplus of offices and other buildings consequent upon the earlier over-investment explains why non-residential construction has been exceptionally weak. But, investment in plant and equipment also has been weak (see Graph 2). Slack demand conditions and the preoccupation of borrowers with debt reduction have been important factors here.

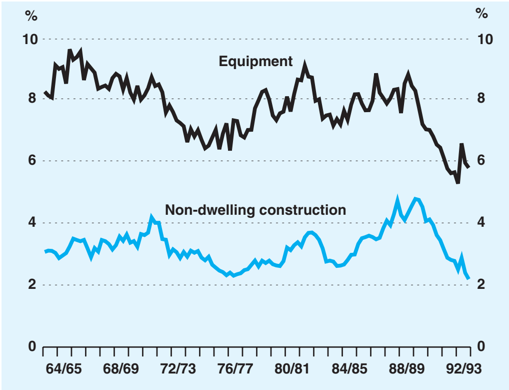
Some uncertainties remain. In particular, growth, while picking up, is still relatively slow, and major structural problems in Japan and Europe dim the prospects of any marked acceleration in the near future.

Graph 1



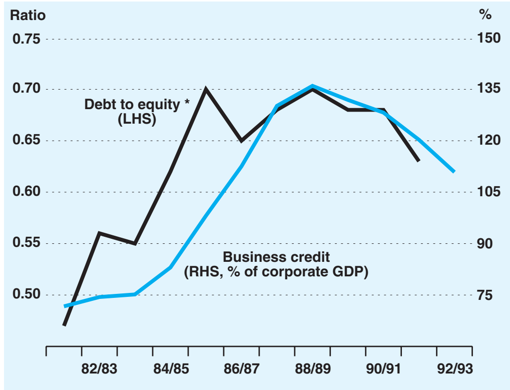
Graph 2

BUSINESS FIXED INVESTMENT
Per cent of GDP



Graph 3

CORPORATE GEARING



* Source: Australian Stock Exchange - 96 large companies.

Nonetheless, the conditions for stronger investment are falling gradually into place. In particular:

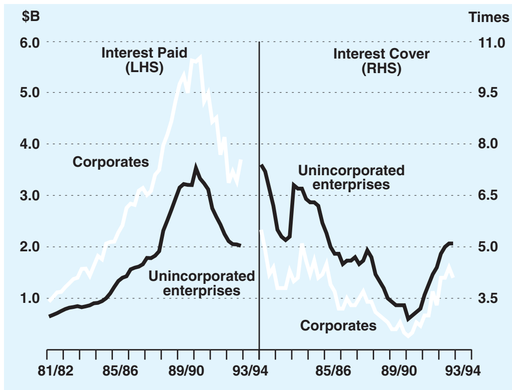
- business balance sheets have been improving and the debt burden has become less onerous (see Graphs 3 and 4);
- business profitability has improved, particularly after interest payments, which have declined on the back of reduced gearing and lower rates (see Graph 5);
- business confidence has revived as the recovery has broadened and share prices have risen, lowering the cost of equity capital; and
- sustained low inflation will help, over time, to remove a major element of uncertainty and encourage lenders to lend longer.

Reflecting these improvements, investment in plant and equipment has started to pick up. In real terms, it rose by almost 6 per cent in 1992/93. Figures released today point to a further 4 per cent increase in the September quarter, to a level 9 per cent higher than a year earlier.

Companies in the private and public sectors are working their existing capital harder – which is a good thing – but, over time, substantial new investment will be needed to accommodate stronger growth in output and employment.

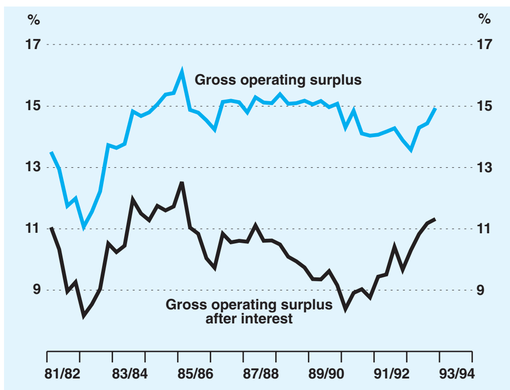
Graph 4

INTEREST COSTS



Graph 5

COMPANY PROFITS
Per cent of GDP



Financial Sector Changes

Internally generated funds are the main source of investment capital but banks provide the lion's share (around two-thirds) of the external borrowing of businesses. Banks, therefore, are significant players in business investment.

The financial system as a whole can be expected to adapt to meet the financing needs of higher levels of investment. Financing has not been a problem in the past; indeed, the large stock of vacant office blocks and shops testifies to a surplus, rather than a shortage, of funding. But no individual institution is guaranteed its place in the financial sector. The 1990s are bringing a different set of challenges, but the need for adaptation is no less than it was with deregulation in the 1980s.

I mention just two changes that will require some adaptation by banks and other financial institutions.

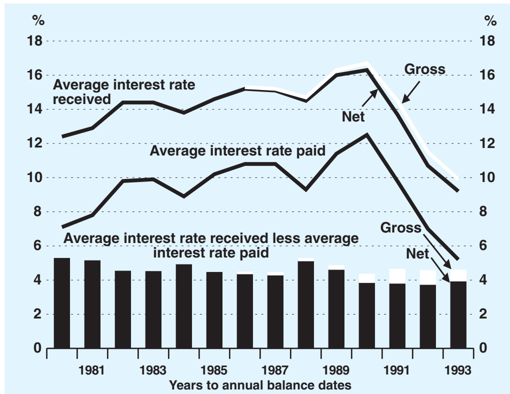
First, much of the investment in the 1980s was funded from overseas — in, for example, the US and Euro-bond markets. The counterparts of these large capital inflows were large current account deficits, which averaged around 5 per cent of GDP in the 1980s. We expect to see those deficits reduced significantly over the years ahead as domestic savings recover. National savings will be enhanced by the projected reduction in the budget deficit, and by increased private saving through superannuation.

Secondly, banks and others will have to continue to adapt to the heightened yield sensitivity of lenders. The days when depositors would leave money with banks at low or zero rates of interest are gone. All that changed in the 1980s, when savers became accustomed to high nominal interest rates. As inflation has come down and nominal interest rates have fallen, savers have been searching around for higher yields. The move of 'the little people' into equities is one example of this change.

Institutions which in the past enjoyed substantial low interest funding have had to adapt to this new world. To date, the relatively higher funding costs have tended to be passed on to borrowers in higher loan interest rates. In the years ahead, as the benefits of cost cutting programs become more apparent, we would expect to see some reductions in bank interest spreads – which, averaged across the four majors, have not changed much in recent years (see Graph 6).

Graph 6

DOMESTIC INTEREST SPREADS
Major Bank Groups



The net domestic interest spread is the difference between the average interest rate received on interest earning assets (including non-accrual loans), and the average interest rate paid on interest bearing liabilities plus current deposits not bearing interest. Estimated interest forgone on non-accrual and restructured loans is added to average interest received to calculate the gross spread figure.

Do Banks Have a Future?

Some commentators believe banks are destined to shrink, if not disappear. Last year, *The Economist* magazine, for example, posed the question: 'does banking have a future?'. Its answer was that 'it does not take a visionary to imagine a world without banking'.

Such a view is clearly not based on some banks' recent difficulties. If it was, it could be largely dismissed, given the good progress which banks (both here and in some other countries) have made in working off the burden of non-performing loans. This process accounts for much of the recent improvement in bank profitability. At the same time that non-performing loans have been falling, Australian banks generally have continued to build up their capital ratios.

The Economist view instead contends that continued technological innovation, closer integration of national financial markets and increasing competition will erode the pre-eminent position of banks, and continue to blur the distinction between banks, other financial institutions and securities markets.

One strand to this argument is that banks will find it increasingly costly to raise funds as households shift out of bank deposits into other assets. Another, is that a greater volume of lending will be done through the securities markets directly (and indirectly through securitising certain assets off bank balance sheets).

These arguments raise many issues which I can only touch upon here. In the end, how the banks themselves adapt to change will also help to determine their future.

Bank Deposits

On the liabilities side of the balance sheet, bank deposits have several attractions for individuals which will help banks to retain their core role. They are at the low end of the risk spectrum and they are highly liquid. For many individuals, bank deposits are the main asset in which they hold their financial wealth; deposits at banks still represent about 30 per cent of household financial assets. Banks also provide payments services.

The growing share of assets held in life offices and superannuation funds is sometimes pointed to as evidence of the declining importance of banks. At least to this time, however, the growth in assets held in superannuation funds reflects mainly reinvestment of the high earnings of the 1980s, rather than higher contributions from individuals. That is, to date it does not reflect deliberate action by people to shift more of their assets into superannuation funds and away from banks and other intermediaries.

That said, superannuation funds seem likely to become a larger part of the financial sector as the Superannuation Guarantee Levy rises. I support this push for greater saving for retirement but it does imply a significant reshaping of how wealth is held in the community, with superannuation assets likely to grow relative to other financial assets.

This raises the prospect that savings will in the future be channelled away from bank deposits into superannuation funds. People are unlikely to hold as much as they would otherwise in other forms of wealth (deposits, government securities, equity and perhaps housing) when they are forced to save more through superannuation funds.

On the other hand, banks will continue to play a role in directing funds to various end users. Someone will have to perform that role – a role which is likely to grow if Australia is to fund a larger proportion of its investment through enlarged domestic savings. Banks might be able to securitise some assets or issue liabilities that are held by superannuation funds. The process need not, therefore, imply a smaller role for banks in absolute terms: they may have a smaller share of the financial sector, but the sector would be larger.

Bank Business Lending

So far as banks' business lending is concerned (my main focus tonight), it is true that some borrowers are obtaining funds outside the banking system. Large firms with good credit ratings, for example, are increasingly raising funds directly in the securities markets. Some firms appear able to raise funds more cheaply than banks themselves. (In addition, in some countries, securitisation has tended to take home mortgages and some other good quality assets off bank balance sheets.) Even in the United States, however, where these developments are most advanced, they clearly have not rendered banks obsolete.

One area where banks (and especially domestic banks) have an opportunity to enhance their role is in financing small and medium businesses. These businesses are an important part of our growing economy. So far in the recovery, virtually all the growth in employment has come from businesses which employ fewer than 20 people. Over the years ahead, small and medium sized businesses are seen as major sources of jobs and exports. For this to occur, a number of things need to happen, of which one – *but only one* – is that these businesses have reasonable access to finance.

Banks are the logical provider of funds to relatively small firms not able to tap financial markets in their own name (either by issuing debentures or equity), and generally not sufficiently well known to borrow directly from large wholesale financial institutions. Even if large firms do increasingly look after themselves, this will still leave a potentially huge business customer base for banks.

The essential characteristic of lending to smaller firms is that a large amount of information specific to the firm is required to help assess the creditworthiness of the borrower. Among financial institutions, the banks are best placed to build up this information. It is the sort of information bank managers might acquire, not only through the routine management of their customers' lending and deposit accounts, but also through the often subjective judgements which good managers can make – the knowledge which managers get from visiting businesses to 'kick the tyres' and from close contact with their local business community. Gathering and processing this information is the heart of successful intermediation.

The problems are also prodigious, which probably explains why many bankers are less enthusiastic than I might appear to be. First and foremost is the cost of assembling sufficient information to assess the borrower's proposal. This cost can be as great for a small loan as for a large loan and it ultimately has to be met by borrowers. The high failure rate for small business loans compounds the problem; if, say, 2 per cent of such loans fail, banks need a margin of this order on all their loans before allowing for the other costs involved.

In these circumstances, it is hardly surprising that, in practice, banks tend to trade off the costs of gathering information against the provision of security. That is understandable, but better information could also broaden the base for lending to small and medium sized businesses.

I believe that banks generally are keen to lend more to small businesses where they can be reasonably confident of getting their money back. Many have introduced relatively attractive packages for such borrowers. At the same time, many banks also acknowledge the need for more skilled staff and extra training to handle small and medium business borrowers.

All this takes time but I would like to see it given a higher priority. Banks were slow to adapt their risk assessment and management skills to the changes wrought by deregulation in the 1980s. They need to move more quickly now to master the art of credit assessment for small and medium businesses so that they are prepared for the pick-up in demand for credit from these businesses when it comes.

More generally, any action which reduces the heavy information gathering costs would be a step forward. To this end, the Reserve Bank is looking closely at the work being undertaken by several groups to streamline the information banks require from small businesses.

Incidentally, the high costs of gathering information to support what are traditional bank lending activities suggest that most banks would encounter even more severe problems in making equity investments. Perhaps more to the point, those bankers who are interested in this possibility tend to focus on larger, rather than smaller, businesses (most of the latter, for their part, are not keen for banks – or other institutions – to own a slice of them).

Conclusion

While the level of business investment remains quite low, recent trends are encouraging. It appears that we are getting closer to finding this 'missing link', which is so important for sustaining growth in employment and living standards over the years ahead.

The banks have a special role in the investment process, helping to identify high return projects and to channel funds to them. They could further develop this role by greater funding of such projects by small and medium firms.

Their main comparative advantage lies in gathering information about those firms which are not large enough to raise money in their own names. By honing their skills on the asset side of their balance sheets, the banks can maintain and increase their role in the evolving financial sector. If they do not exploit their comparative advantage, we can expect pressure for other (and perhaps new) institutions to fill this role.

The Economist article mentioned earlier noted that: 'Prudence, Thrift and Ingenuity make a worthy motto', and that banks which pursue these goals 'will prosper and grow'. As always, the trick for the banks is to strike an appropriate balance. Too much ingenuity could result in more bad lending. But too much prudence could see customers shift their business elsewhere.