Risk, capital markets and the future: a new generation of policy reform

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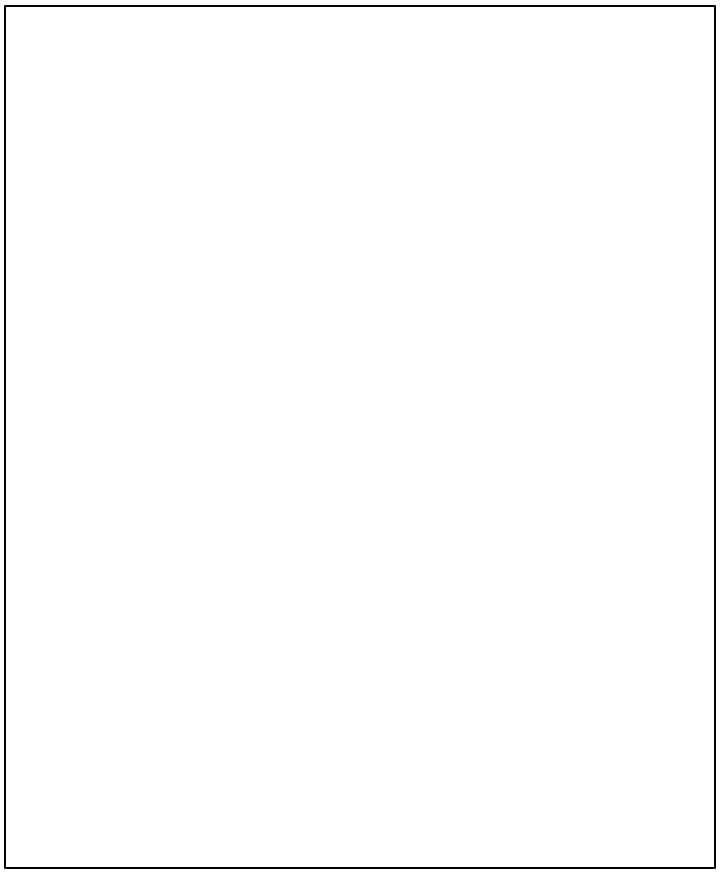
Figure Four: Labour productivity in the business sector 1992-2003 (forecast)



One can diversify to protect oneself from most specific risks – such as risk to a specific project or a specific sector. And if one could diversify away all risks, one would expect the cost of debt and equity to pretty much line up with each

Source:

surpluses in previous years. Elsewhere the Bush administration is demonstrating the fragility of popular support for fiscal responsibility. It is making a vigorous and so far extremely popular return to fiscal profligacy after

The mechanism would operate in close consultation with the government of the

does) it does not necessarily follow that the funds released from that transaction should simply retire debt. Apart from anything else this represents a sale of high yielding assets to fund the purchase of lower yielding assets.

If a well run firm in the private sector were to sell some of its businesses it would consider its appetite for risk (or rather the appetite of its owners – and prospective owners – in the market) and then seek an asset allocation that maximised its risk-adjusted return. If that meant retiring debt – well and good.

efficiency of the market with its own benefits in sharing risk with other investors. It would also operate counter-cyclically – moderating the economic cycle.

A possible institutional framework for such an approach would be a body or several government bodies – such as the Reserve Bank – taking responsibility for macro-economic stability and maximising economically sustainable growth. The body or bodies would play the lead role in managing interest rates, fiscal policy and asset allocation, with private managers competing for funds management contracts and managing stock selection.

As an example of the kind of thing that is possible, take the current unfunded Commonwealth superannuation liability of around $80 billion. Quite apart from

Figure Nine: Stabilising, contrarian investment

Source: "Reserve Bank Operations in The Foreign Exchange Market: Effectiveness and Profitability", Andrew, R and Broadbent, J, Research Discussion Paper 9406, November 1994, Reserve Bank of Australia, p. 5

Of course the government agency will not always be a winner. I expect the sustained fall in the Australian dollar has also tested the Reserve Bank's contrarian prowess. But over time I expect it will continue to beat the market and even if it did not, so long as it does not consistently lose money, the Reserve's intervention in the markets is a manifestation of its belief that its activity generates broader economy wide benefits beyond trading profits and losses.

Even if a government holding of higher yield assets did not beat the market it would enjoy a higher return at an acceptable level of risk. Instead of managing our asset allocation by default we should manage it according to the following principles. We should:

- increase government net worth through the cycle and beyond at least in line with the growth in our economy;[4] and

[4] My own preference is to aim for a gradual increase in government net worth as a percentage of GDP for some time as a prudential measure for a capital importer in a dangerous world in which markets can be capricious and as a means of raising national savings.

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society as older people are forced into a situation where their asset riches cannot save them from their cash poverty. With the ageing of the baby boomers, the problem is growing worse.

There are plenty of other examples. Take the arbitrary prudential rules for safeguarding the value – soon to exceed Australia's GDP – in superannuation funds. In general, superannuation funds are not permitted to borrow or to invest in derivatives.

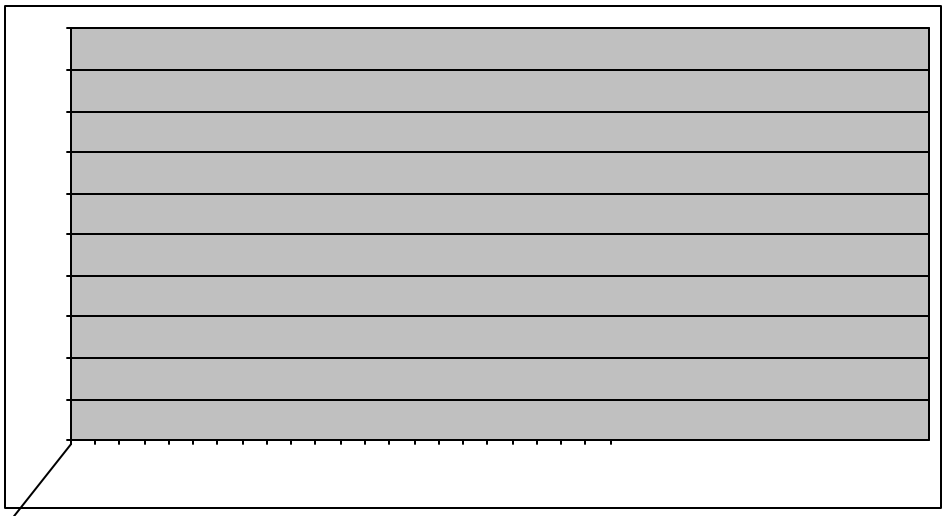
Of course they should not be permitted to do either of these things *imprudently*, but derivatives are a risk management *tool*. And of course fund managers should not be permitted to do either of these things imprudently. But prudential rules for derivatives are

Figure Ten

Investor's initial salary (p.a.)	$65,000
Growth rate of salary (p.a.)	3.5%
Tax rate on fund earnings	15%
SG employer contributions (% salary)	9%
Tax rate on contributions	15%
Initial level of gearing (%)	50%
Gearing reduction rate (p.a.)	1.5%
Interest rate on borrowing	6.50%
Superannuation fund average return (p.a.	10.50%

Our base case with no gearing generates a fund of $1,521,000 when she reaches 55. If she geared her commencing portfolio at 50% in the first five years, falling by 10% each five year period, she would end up with a fund of $1,847,000. This is a difference of 21% (it would be much more but for taxes on fund earnings).

Figure Eleven: Superannuation with and without gearing



international shares and property and some bonds.). There are no compensating increases in yields in the years leading up to or following this crash – so the simulation does not just model higher volatility but also lower returns. Average returns here are 8.68%.

With rising stock prices, increasing investment and lower levels of market volatility we would very likely become a more attractive place to invest. A virtuous cycle would have been established.

Of course nothing in what is here proposed is a panacea.

It won't end the cycle, or prevent all recessions. It won't abolish risk for anyone, though it will improve the form some of the risks take and the way they are managed and shi aenu dl.mcou becnomic systemd.

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7. Appendix

Average Returns to Pooled Superannuation funds from 1963.

Year	*Return*