Financial Deregulation and Financial Markets

Talk by Deputy Governor, Mr I.J. Macfarlane, to CEDA Conference, 'Financial Deregulation: Past Promise – Future Realities', Sydney, 27 April 1995.

Introduction

It is difficult to talk about financial deregulation without rehashing Australian events in the mid to late 1980s. I will try to keep this to a minimum, having already had three goes at it in 1989, 1990 and 1991. Instead, I propose to look at two quite separate subjects: first, the Australian experience in an international context; and second, the influence of international financial markets on domestic policy making.

The Transition Period

Before getting onto the two main topics, a little bit of clarification about what we mean by financial deregulation is in order. Broadly speaking, there were two major aspects of financial deregulation. The first aspect was macroeconomic, and the major policies were the floating of the exchange rate (with associated abolition of exchange controls), and the full implementation of the tender system for selling debt to the public so that the budget deficit was financed at market rates. To the best of my knowledge, these policies have produced little or no public criticism, other than the charge that they give international markets too much influence (a subject to which I will return).

The second aspect of financial deregulation was directed at financial intermediaries, mainly banks, with a view to increasing competition. The major policy changes were the abolition of both interest rate controls and credit guidelines, and the entry of foreign banks. It is this aspect of financial deregulation that has received the most criticism. There is a widespread belief that it contributed to a surge in credit and to a boom and bust in asset prices, which added to the economic cycle in Australia at this time.

It is possible to accept that there is a significant element of truth in this assertion, while still remaining in favour of financial deregulation. In other words, it is reasonable to maintain that a deregulated financial system is superior to a regulated one, as I would, and yet concede that serious difficulties were encountered in the transition process. The superiority of a deregulated system is a view that is held most strongly by those who can still remember the difficulty of trying to get the old regulated system to function in a world that was increasingly economically integrated and where innovation could outpace regulation.

Why is it then that the transition difficulties of moving to a more competitive banking system were under-estimated? I will provide two answers, but there may be more.

1. Economists are trained to describe the characteristics of a system in equilibrium or at least in a reasonably settled state; they can even say that one system is 'better' than another. What they are not good at is analysing a *regime shift* – that is the process whereby one system is replaced by another. This involves an intervening period during which market participants, who have only ever played by one set of rules, are asked to play by another set, and for high stakes. During this time, the consequences of some types of apparently profitable behaviour are not known to the majority of participants. As one prominent Australian banker is reported to have said in the late 1980s, 'I've had thirty-two years' experience, but the first thirty were all the same.'
2. While people with really long memories might have been able to go back to the 1890s or the 1920s to find instruction, most people rely on recent examples from at home or abroad. Unfortunately, there was little relevant recent experience in Australia, and overseas examples were not much help. This is because the Australian asset price boom and bust was relatively early in the international cycle. We had not seen in 1989 and 1990 just how widespread the boom and bust of asset prices would be among OECD countries and hence could not learn from them until it was too late. For example, it is now clear that the extreme case of asset price boom and bust was in the Nordic countries, particularly Finland and Sweden – but this was not fully played out until about 1992, when we saw the collapse of the banking system in these countries.[1] Similarly, the collapse of the bubble economy in Japan did not get going until about 1991.

As well as not learning from other countries in time, a lot of commentators on financial deregulation have still not made the effort of putting the Australian experience into international perspective. For example, there is still a perception that the boom and bust in asset prices in Australia was exceptionally large by international standards. My next section aims to dispel this misconception.

The International Experience

The best summary of these international developments is contained in the 1993 Annual Report of the Bank for International Settlements (BIS), and a subsequent research paper by Borio *et al.* (1994).[2] These both have the great advantage of being written with the benefit of hindsight and so they are able to survey the international scene from a vantage point not available to Australian observers even a few years earlier.

Because the BIS economists were mainly interested in the growth of credit and asset prices, they constructed asset price indices for OECD countries from 1970 using the same methodology as we at the RBA had employed in our earlier work. That is, they built up the aggregate index for each country from price indices for shares, residential property and commercial property. This was a pretty ambitious task, and the indices are only approximations of the broad trends over 20 years. Nevertheless, they felt they were able to draw some clear conclusions. Let me quote:

> 'Asset prices have played a prominent role in the (recent world) business cycle, both in terms of the amplitude

1. It is estimated that the volume of official operations used to support the banking systems in Norway, Sweden and Finland up to 1993 amounted to 3.1 per cent, 4.7 per cent and 7.3 per cent of GNP respectively. See Bank for International Settlements (1993), *63rd Annual Report*, Basle.
2. Borio, C.E.V., N. Kennedy and S.D. Prowse (1994), 'Exploring Aggregate Asset Price Fluctuations Across Countries: Measurement, Determinants and Monetary Policy Implications', Bank for International Settlements, Economic Paper No. 40.

> of their fluctuations and because of their impact on financial institutions and economic activity. Such medium-term swings are, of course, not new; the last similar episode took place in the early 1970s. What has drawn attention to the recent asset price movements is not only their absolute size and geographical compass, it is also the fact that the prolonged upswing, in contrast to the previous one, occurred *against a background of positive inflation-adjusted interest rates*.' (italics added)

In other words, there may have been large rises and subsequent falls in some asset prices in the 1970s, but that is only to be expected in a period of accelerating inflation and where real interest rates were low or negative. In the 1980s, however, there was asset price inflation in most countries even though general inflation was decelerating and real interest rates were high. This was a conjunction that no-one had experienced.

When turning to the experience of individual countries, they comment:

> 'While a large number of countries experienced a cycle in real aggregate asset prices over the last 10 years, the severity of asset price inflation and deflation varied widely. The sharpest movements occurred in some of the Nordic countries and in Japan.'

The BIS survey of asset price rises puts Australia in the middle of the field. The increase in Australian asset prices between 1982 and 1989 was 155 per cent in nominal terms and 59 per cent in real terms (consumer prices rose by 60 per cent, or 7 per cent per annum). This sounds like a lot, and I do not wish to suggest that it was otherwise. However, a number of other countries had much more pronounced asset price booms (and busts). The summary table below gives some figures.

While we could quibble with some of these numbers – for example, the United States looks surprisingly low – it is hard to see how the results for some of the high-fliers could be altered greatly by measurement approximations.

Table 1: Increase in Real Asset Prices

Country	Cumulative percentage change	Period covered
Finland	191	1978 - 1988
Japan	164	1977 - 1989
Sweden	114	1980 - 1989
United Kingdom	102	1981 - 1989
Norway	73	1980 - 1989
Australia	59	1982 - 1989
Canada	52	1984 - 1989
Germany	39	1987 - 1991
United States	37	1981 - 1989

Source: Borio *et al.* (1994)

The BIS makes several attempts to explain the growth in asset prices by the growth of output, inflation and interest rates without much success. In the end, their analysis leads them to the crucial role played by credit.

'To a large extent, this rapid growth (in asset prices) reflected *a relaxation of credit constraints in the financial industry* in the wake of both market-driven and policy-determined structural changes. The end result of those changes was greatly to increase competitive pressures in the industry and to broaden the range of borrowing opportunities. In the process, they also heightened the *impact of pre-existing tax provisions* which encouraged indebtedness and which had been less effective during the period when credit rationing was prevalent.' (italics added)

In other words, every country seemed to have an asset price boom of some sort in the 1980s, and ours was not exceptional by international standards. Also, each of these booms was associated with a relaxation of credit constraints, although not all of them could be attributed directly to a sudden financial deregulation. Certainly the Nordic countries were in that category, but Japan made only limited and gradual steps towards deregulation. This suggests that international competitive pressures swept a number of countries along even though policy makers were reluctant to deregulate.

The Influence of Financial Markets

The papers in this conference all key off an admirably even-handed paper by Fred Argy.[3] While Fred is prepared to give credit to financial deregulation for improving micro-economic efficiency, he feels that it has had the unintended effect of giving international financial markets too much power over domestic economic policy. I won't quote Fred in detail, but he says in various places that governments take a long-term view, but markets are prone to short-termism; that markets are prone to error because of their inability to fully read the policy intent and resolve of the authorities; and that they unduly penalise governments pursuing social and environmental priorities.

It is worth spending a bit of time on this subject because, while I understand some of Fred's frustration with financial markets, in the end I come to the opposite view. I believe that, over time, markets play a useful role in helping countries put in place sustainable macro-economic policies in the face of some quite powerful forces pushing in the opposite direction.

I am prepared to concede that in all markets where prices are freely determined, their movements often seem illogical, even after the event. Medium-term movements, whose direction is based on fundamentals, often go too far, i.e. overshoot, and there are often short-term over-reactions to pieces of news. There is now a burgeoning literature on bubbles, overshoots, positive feedback, etc, rather than the general agreement on the Efficient Markets Hypothesis that characterised the economic literature a decade ago. But these distortions are essentially short run, and can justify a country ignoring market pressures for a time. There is no reason, however, to believe that market pressures could systematically cause a country to run bad policies or to eschew good policies in the long run – that is, over a run of years or a decade.

International investors, whether they are based in Australia or abroad and whether they are using their own money or managing funds for clients, aim for high returns, and try to avoid losses. This latter aversion makes them reluctant to invest in countries – whether it is their own or a foreign one – whose policies are likely to lead to their investments losing value. In particular, they are wary of countries whose fiscal policies result in large budget deficits and whose monetary policies result in high inflation and a weak currency. Provided it is based on facts, I cannot see why this behaviour on the part of international investors is a bad thing, even viewed exclusively from the perspective of maximising economic growth and social equity. When did large budget deficits and high inflation ever help to attain either of those two worthy objectives?

The greatest contribution that macro-economic policy can make to those objectives is to stay on a sustainable path. The biggest setbacks to growth and employment do not occur in the normal year-to-year adjustment of policy – they occur when governments are forced to tighten fiscal and monetary policy sharply to retrieve an untenable external position or bring back a rate of inflation that has got away. International markets can, and often do, provide the discipline that helps domestic policy makers avoid the trap of letting macro-economic policies slip into the unsustainable zone. Fred talks sympathetically of Sweden because of the harsh treatment they have received from the markets. We must remember that Sweden allowed a situation to develop where they had a budget deficit equivalent to 13 per cent of GDP and a rate of inflation of 10 per cent. I suspect that there are a lot of Swedes who wish their system had allowed the market to exert pressure a lot earlier in the piece, so they could have avoided this unsustainable policy predicament and its painful rectification.

It is not very illuminating to see the policy

3. Argy, F. (1995), 'Financial Deregulation: Past Promise, Future Realities', CEDA Research Study, p.42.

formulation process as a conflict between only two parties – the government and the markets. What we are dealing with is a government trying to put together coherent macro-economic policies in the face of pressures from numerous interest groups. A minimal list would include various industry groupings, such as manufacturers, exporters and farmers, trade unions, social welfare groups, other single-interest pressure groups, the press, and various lobby groups, not to mention backbenchers in marginal seats. Looking down this list, it is clear that hardly any of these ever speak out in favour of the difficult, but often necessary, tasks of cutting expenditure, raising taxes or raising interest rates. Financial markets represent another type of pressure group that acts as a counterweight to the list above. If someone was to find a way of eliminating the bias of financial markets, I would be more reassured if they could also do something about the bias inherent in the demands of domestic pressure groups. This would, of course, be impossible, so it is better to have the two countervailing sets of pressure in operation.

It is part of the story that is played out in all liberal democracies – the difficulty of reconciling medium-term policy needs with the individual policy changes that affect sectional interests. Often the sectional interests win, and some observers see this as a win for democracy, but is it? We have just seen the US Republicans win by a landslide in the November Congressional elections on a platform that included a balanced budget as a major plank. By March they had to admit defeat on this policy; they could not get the sectional interests to make the changes necessary to achieve an outcome that a few months earlier had been endorsed at the ballot box.

The influence of financial markets is not going to solve these problems at a stroke, but they can at times make a useful contribution. For example, one of the most successful pieces of Australian medium-term macro-economic policy making in recent memory, from which we are still benefiting, was the achievement of a budget surplus in the four years from 1987/88 to 1990/91. It is always difficult to turn an adverse budgetary position around, and many countries have failed to do so. Australia's success on this occasion was helped by the pressure exerted by financial markets; it made it easier to bite the bullet and override sectional pressures in the national interest.

To this point, I have only mentioned financial markets' distaste for large budget deficits and inflation – I have not discussed current account deficits. The reason is that for every complaint about markets being tough on countries with large current account deficits, we have the opposite complaint that markets are too tolerant of such deficits and too willing to finance them. Perhaps this is because current account deficits are not always a bad thing, as Fred noted, whereas a large entrenched budget deficit and high inflation always are. Perhaps it is also because current account positions are a zero sum game; for every surplus country, there has to be a deficit one. Whatever the reason, it is hard to argue that markets prevent a country with a defensible reason for having a current account deficit from continuing to do so. Thailand would be a good example of this. On the other hand, when they judge that a current account is getting too large, or being used to support consumption, then they usually bring some pressure to bear via the exchange rate or interest rates. In this respect, Australia is not in a strong position to argue that, over the past decade, financial markets have treated it unfairly.

Conclusion

Most of the complaints in Australia about financial deregulation concerned events that happened in the transition period between the old regime and the new. We should concede that in this phase there were unforeseen consequences in the form of an asset price boom and bust. We were not alone, however, in having this experience during the late 1980s, and contrary to popular conception, our experience does not stand out as being extreme by the standards of OECD countries.

On the issue of whether deregulated financial markets contribute to good macroeconomic policy or not, I come down strongly in the affirmative. We can all find fault from time to time with aspects of market behaviour, but we would find more fault with the alternative ways of allocating capital, if we had to look at them closely. Like democracy – which Churchill characterised as 'the worst form of government, except all those other forms that have been tried from time to time' – the market is the least bad way of allocating capital.