AUSTRALIA'S EXPERIENCE WITH FINANCIAL DEREGULATION[1]

Address by Mr Ric Battellino, Deputy Governor, to China Australia Governance Program, Melbourne, 16 July 2007.

Introduction

It is a great pleasure to be able to share with you some of Australia's experiences with financial deregulation. Even though the process of financial deregulation in Australia was largely completed 20 years ago, many of the lessons learnt from that experience remain relevant today. I think they are particularly relevant for today's seminar because Australia's financial controls prior to deregulation had much in common with the financial controls we see in China today.

I should also mention that while financial deregulation in Australia was largely completed 20 years ago, the reform process did not end there. In the period since, there have continued to be changes to the laws under which the financial sector operates, to ensure that the sector remains dynamic and competitive.

The Australian System Pre-deregulation

Financial deregulation in Australia began in the early 1970s. At that time, there were wide-ranging controls on the financial system. The aims of those controls were to:

- provide the authorities with the mechanism to manage the monetary side of the economy;
- create a captive market for government securities, so as to allow the Government to fund itself;
- limit the risks that banks could take – i.e. they were a de facto form of prudential supervision;
- allocate credit to areas of the economy that authorities thought should get priority. Housing and farming were particularly favoured; and
- maintain a stable exchange rate and prevent the flow of domestic savings offshore.

1 *This talk draws heavily on a number of studies that the Bank has undertaken of Australia's financial deregulation. Some of the key ones relating to the early phase of deregulation are: I Macfarlane (ed) (1991),* The Deregulation of Financial Intermediaries, *Proceedings of a Conference, Reserve Bank of Australia, Sydney, 20–21 June; M Edey (ed) (1996),* The Future of the Financial System, *Proceedings of a Conference, Reserve Bank of Australia, Sydney, 8–9 July; Gizycki M and P Lowe (2000), 'The Australian Financial System in the 1990s', in D Gruen and S Shrestha (eds),* The Australian Economy in the 1990s, *Proceedings of a Conference, Reserve Bank of Australia, Sydney, 24–25 July, pp 180–215; Edey M and B Gray (1996), 'The Evolving Structure of the Australian Financial System', RBA Research Discussion Paper No 9605; Battellino R and N McMillan (1989), 'Changes in the Behaviour of Banks and their Implications for Financial Aggregates', RBA Research Discussion Paper No 8904.*

The controls that were put in place to further these objectives were extensive. Listing them all could easily fill up the whole time allocated to me, so let me cut them down to their essential elements.

1. The interest rates that banks could charge on loans and pay on deposits were controlled, and generally did not vary much. This effectively prevented banks from managing or, more specifically, expanding their balance sheets.
2. Banks were subject to reserve ratios and liquidity ratios. These ratios were used by the authorities to control the second-round effects on bank balance sheets of exogenous flows of liquidity from either the balance of payments or fiscal policy.
3. Banks were subject to directives on the overall quantity of loans and at times there was moral suasion in relation to the industries to which loans should or should not be made.
4. Institutions were specialised: trading banks lent to businesses; savings banks lent to households, almost entirely for housing; and finance companies lent for more risky property loans and consumer credit.
5. All transactions in foreign exchange were closely controlled, particularly capital transactions, which were individually approved. Australians by and large were not allowed to make portfolio investments offshore, mainly because the authorities wanted to preserve domestic savings for domestic investment.
6. The exchange rate was managed very tightly. Australia did not join the many other developed economies that moved to a floating exchange rate after the breakdown of the Bretton Woods arrangements in the early 1970s.

Reasons for Change

Why did Australia move away from this system? I think there are four broad reasons.

- First, being heavily focused on banks, the controls were weakening the position of banks and hampering their ability to respond to customer needs. Banks were rapidly losing market share in the financial system; by the early 1980s their share had fallen to 40 per cent, compared with 70 per cent in the early 1950s.
- Second, the controls were becoming ineffective, as new, unregulated, intermediaries sprung up to provide finance.
- Third, the increase in international capital flows following the breakdown of the Bretton Woods arrangements began to put pressure on the Australian dollar exchange rate. The authorities could stabilise the exchange rate only by engaging in large foreign exchange transactions, which in turn made it difficult to manage domestic liquidity and domestic financial conditions more generally.
- Fourth, the financial system was quite inefficient, with wide interest spreads, little innovation and many creditworthy potential borrowers unable to get access to credit.

The Start of the Deregulation Process

By the time I joined the Reserve Bank in the early 1970s, there was already an active internal debate about the need for change. But there was also a fear that change could lead to a loss of control over the financial system. In any event, the power to make changes did not rest solely with the Bank; many of the financial controls were embedded in legislation and therefore the Treasury and the Government needed to be convinced before any changes could be made.

The early moves towards deregulation were tentative. There was an alternative school of thought that the problems with the controls in place could be overcome simply by extending their range and reach. For example, legislation was prepared to extend controls to the new non-bank intermediaries which were springing up because of the controls on banks. This legislation was never proclaimed, however, as the intellectual drive towards deregulation eventually dominated.

One of the first major steps in the deregulation process was the removal in 1973 of controls over the interest rates that trading banks could pay on some wholesale deposits. This was seen as a modest, cautious step to allow banks a degree of freedom to compete.

This ended up having far-reaching consequences. It led to a sequence of changes, each one begetting the next, until 13 years later virtually all controls on banks had been removed, foreign banks had been allowed to enter the market and the exchange rate had been floated.

The key changes in this sequence were as follows:

1. The removal of interest rate controls on banks. As noted, this began in 1973 and was designed to allow banks to compete more effectively for deposits and loans. It did this, but it also had the unintended consequence of reducing the effectiveness of the reserve and liquidity ratios on banks. This was because banks could now counter a change in the reserve ratio by adjusting their deposit interest rates to compete more aggressively for funds. These funds often came from foreign capital inflows, as the relatively fixed exchange rate necessitated intervention by the Reserve Bank, which added to bank liquidity. The Reserve Bank then had to rely on market operations in government securities to control liquidity, but the effectiveness of these was limited because interest rates on government securities were generally set too low by the authorities, making it difficult to sell the required amount of securities.
2. To address this latter problem, further reforms were introduced to free up interest rates on government securities. Instead of the authorities setting these interest rates, securities were issued at tender, and the market set the interest rate. Tenders were adopted for Treasury notes in 1979 and Treasury bonds in 1982. This had the desired effect of allowing both the Government, through primary issue, and the Reserve Bank, through operations in the secondary market, to sell the required amount of bonds. But this still did not give the authorities effective monetary control, as evidenced by the limited success in achieving the monetary targets that were in place at that time. The relatively fixed exchange rate remained a weak point in the monetary control process, as attempts by the Reserve Bank to change monetary conditions were significantly offset by private capital flows.
3. This weakness was not overcome until the exchange rate was floated in 1983. The authorities had been gradually moving to introduce greater flexibility in the exchange rate since 1971, but none of the exchange rate regimes introduced over the ensuing decade or so provided

sufficient flexibility to ensure that domestic monetary policy was not overwhelmed by foreign capital flows. The float changed this. It allowed the exchange rate to vary with the forces of supply and demand and eliminated the need for the Reserve Bank to clear the foreign exchange market. This severed the influence of foreign capital flows on domestic liquidity and gave the central bank the power to control domestic financial conditions. It allowed the implementation of monetary policy to move away from the use of reserve and liquidity ratios on banks to the use of market operations to influence short-term market interest rates and, through that channel, the interest rates that all lenders charged on loans. This resulted in monetary policy working more broadly through the financial system, rather than being focused only on banks, making it more effective and also less distorting.

4. The final set of measures aimed to increase competition in the financial sector. The main reform was to allow foreign banks to enter the Australian financial system, but processes for establishing new domestic banks were also eased.

What Lessons Can Be Drawn?

Let me end by drawing together some of the key points that we learnt from the process of deregulation in Australia.

- The first point is that it is very important to harness public and community support for change. Even though the intellectual climate within the Reserve Bank and other economic policy agencies was already moving in favour of deregulation in the early 1970s, wider community acceptance of the case for change did not come until after the Government set up a broad-ranging inquiry, conducted by a group of independent experts.
- Second, the reform process can take a long time to implement because controls are typically removed sequentially. While it is possible to take a 'big bang' approach and remove many regulations simultaneously, such a process can be difficult to manage. In Australia's case, it was not regarded as feasible to remove regulations simultaneously, mainly because of uncertainty about the consequences. While public inquiries had mapped out a range of reforms that needed to be introduced, the sequencing of these reforms was determined in a pragmatic way, in response to unfolding events and the consequences of previous reforms.
- Third, the consequences of reforms are not always entirely predictable. Our experience was that the removal of one set of controls often put pressure on other controls. This meant that the reform process, once it had begun, developed its own momentum.
- Fourth, some of the effects of reforms may take longer than expected to emerge. For example, one of the predicted consequences of deregulation was an increase in the competitiveness and efficiency of the banking sector. Yet, in the retail lending market in Australia, interest margins remained high for about a decade after the reforms. Part of the problem was that new banks found it difficult to enter the retail market as they lacked the widespread branch network of established major banks. These branch networks not only supplied low-cost retail deposits but also provided the distribution outlet for loan products. It was not until further financial innovation – such as the development of securitisation markets, mortgage brokers and electronic banking – took place that these barriers to competition were broken down.
- Fifth, removing controls on banks will almost certainly result in a surge in credit growth. This reflects both demand and supply influences. A regulated financial system often tends to

result in credit rationing, so there is unsatisfied demand for credit in the community; this is able to be met once the controls are removed. Also, the removal of controls can result in an increase in competitive behaviour by intermediaries as they try to increase, or even protect, market share; the end result is an increase in the willingness to supply credit.

- Sixth, it is important to ensure that a sound prudential supervision framework is developed as regulatory controls on banks are removed. Under a regulated financial system, banks have little incentive or need to develop their risk management skills, as interest rates and exchange rates are relatively steady and credit rationing limits the extent to which risky borrowers can access loans. Once regulations are removed, competition can result in a surge in risk-taking. Domestic banks may be particularly vulnerable as their risk management systems may be less developed than those of foreign banks. Supervisors need to be prepared for this and need to monitor developments in the banking system closely.

The final point I would make is that the benefits of deregulation are broad-ranging and powerful. I would categorise these benefits into two types. The first relate to improvements in the operation of the financial system. Once regulations are removed, the financial sector becomes not only more efficient but also more responsive to the financial needs of the economy. New financing techniques and markets develop, resulting in a more diversified and resilient financial sector.

The second set of benefits relate to improvements in monetary control. In the Australian experience, notwithstanding some significant transitional difficulties, the move away from using direct controls to implement monetary policy to a system based on market operations ultimately gave the authorities greater scope to manage the economy, and helped pave the way for a return to economic stability.