AUSTRALIAN FINANCIAL DEREGULATION AND THE GROWTH OF THE FOREIGN DEBT

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The last decade has seen an almost complete deregulation of Australia's financial markets, with the dismantling of regulatory controls proceeding at a furious pace. In a comparatively short period of time most lending, borrowing and foreign exchange restrictions were lifted, the currency was floated and the banking system was opened up to new entrants, so much so that the number of banks operating in Australia more than doubled between 1984 and 1987.[1] The financial system

1 Excluding State banks. If building society branches are included, by 1987 Australia had one bank branch for every 2000 people. This compares to similar ratios of 1:3800 for the United Kingdom and 1:5500 for France (Hughes, 1987).

The process and details of Australian financial deregulation during the 1980's have been well documented in the various RBA *Bulletins* cited amongst the references. Briefly, during and following the deliberations of the Committee of Inquiry into the Australian Financial System (the Campbell Committee) and the Review Group on the Australian Financial System (the Martin Review Group), financial deregulation occurred at a rapid pace.

In a comparatively short space of time Treasury Notes were offered at tender (December 1979), ceilings on interest rates paid on bank deposits were removed (December 1980), a tender system for Treasury bonds was introduced (mid1982), the Australian dollar was floated and most foreign exchange controls abolished (December 1983) , maturity restrictions on bank deposits were removed (August 1984), bank interest rate ceilings virtually became nonexistent (with the exception of certain home loans) (April 1985), and sixteen foreign banks were pre1980 had been dominated by a plethora of direct controls, which involved an extensive array of volume and price constraints on bank lending, maturity restrictions on bank deposits and foreign exchange controls. There had been widespread concern that the existing system lacked the structural flexibility required for the economic and financial management of the country. The Australian financial system had been one of the most restricted amongst OECD countries.

Coincident with this deregulatory process was an equally rapid transformation in Australia's foreign debt. By every devisable yardstick, domestic or international, the last decade has seen a substantial deterioration in Australia's external accounts. Debt (whether gross or net) has risen rapidly in absolute terms, as a proportion of GDP, on a per capita basis and relative to export earnings. Interest payments on this debt have escalated and this has impacted severely on the current account.

Although the literature has debated a number of possible causes of foreign debt escalation at length, surprisingly little attention has been given to the role of financial deregulation. This paper is directed at this deficiency in the literature and considers the impact of financial deregulation on the growth of the external debt. The paper consists of four sections. The first section examines the structure and growth of Australia's foreign debt. The second section focuses on the changing composition and funding techniques of the Australian financial sector, with special emphasis on foreign currency transactions. The third section examines recent trends in private and public sector credit, and finally the fourth section presents this paper's main conclusions.

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invited to establish operations in Australia (February 1985). Seven foreign banks actually opened in 1985 and nine in 1986. The longstanding LGS convention was replaced with a Prime Assets Ratio (May 1985), the SRD requirement was removed (September 1988) and, changes to the Banking Act removed the distinction between Trading and Savings Banks (December 1989).

In addition, some new Australian-owned banks were established, numerous authorities were granted to Non-Bank Financial Intermediaries (NBFI's) to trade in foreign exchange and new industrial and merchant banks were established.

The Structure of Australia's Foreign Debt

The main features of Australia's foreign debt are described in Figures 1 to 7. Data sources are given in the Appendix. All years mentioned are ended 30th June.

FIGURE 1: AUSTRALIA'S EXTERNAL DEBT
($A BILLION)

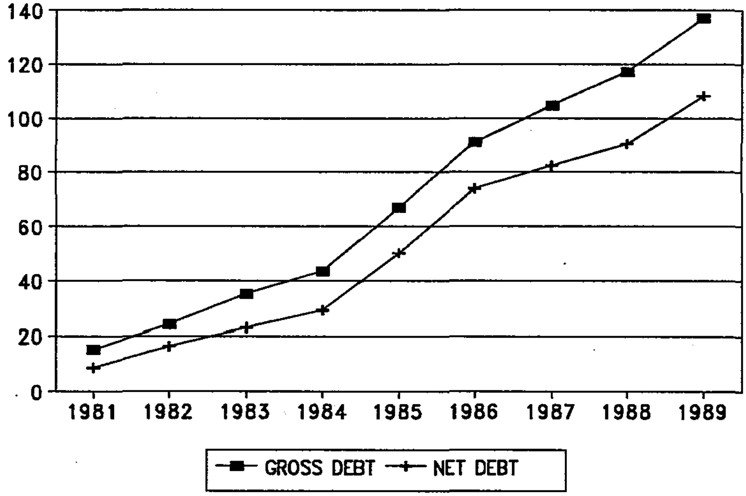

Figure 1 shows the growth of Australia's external debt in absolute terms. Gross debt was slightly over $15 billion in 1981 and rose rapidly throughout most of the decade to be just short of $140 billion by June 1989. The pattern for net debt (gross debt less external assets) shows an almost identical trend, starting at just under $10 billion in 1981 and growing to nearly $110 billion by 1989.

FIGURE 2: AUSTRALIA'S EXTERNAL DEBT
(PER CENT OF GDP)

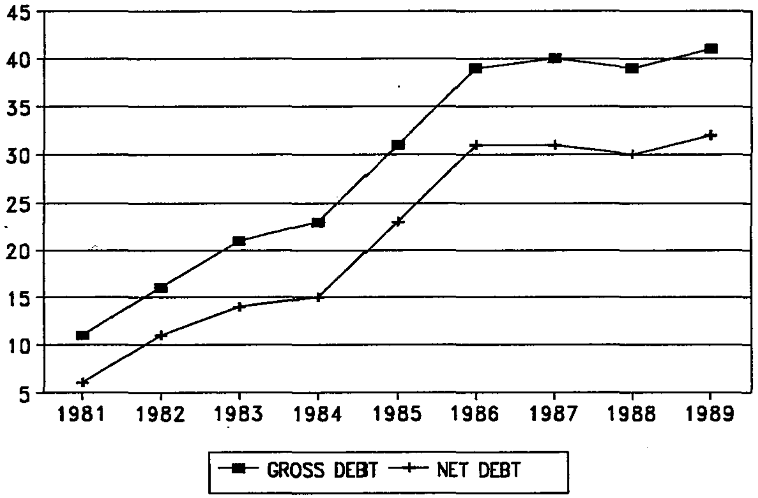

Figure 2 examines the ratio of foreign debt to Gross Domestic Product. The gross debt ratio was just over 10 per cent in 1981, before accelerating away to nearly 40 per cent in 1986; the gross debt/GDP ratio was slightly more than 40 per cent in 1989. A similar pattern is evident for net debt. In 1989 net debt was just over 30 per cent of GDP.

FIGURE 3: NET EXTERNAL LIABILITIES
(PER CENT OF GDP)

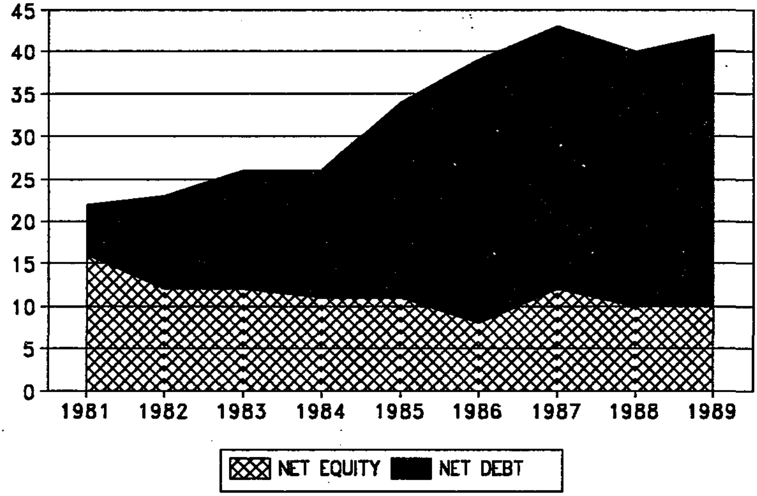

Figure 3 shows the ratio of Australia's net external liabilities (foreign debt plus externally held equity) to GDP since 1981. The chart shows that this ratio almost doubled during the 1980's, to be over 40 per cent in 1989.[2]

It will also be evident that equity investment fell fairly steadily as a percentage of net external liabilities over the same period.

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2 However this figure is comparatively low by Australian historical standards. According to figures in Butlin (1977) estimated external liabilities were 180 per cent of GDP in *1901*. For a full discussion of how net equity and debt are measured see ABS, (1985/86).

FIGURE 4: AUSTRALIA'S FOREIGN DEBT
PER CENT OF TOTAL EXPORTS

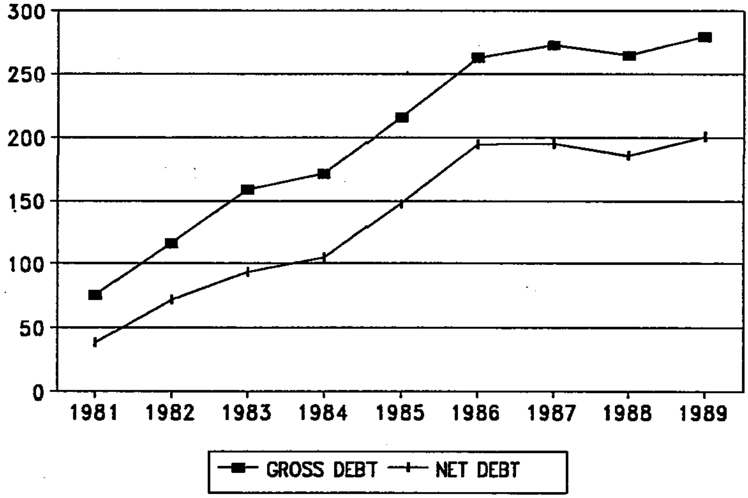
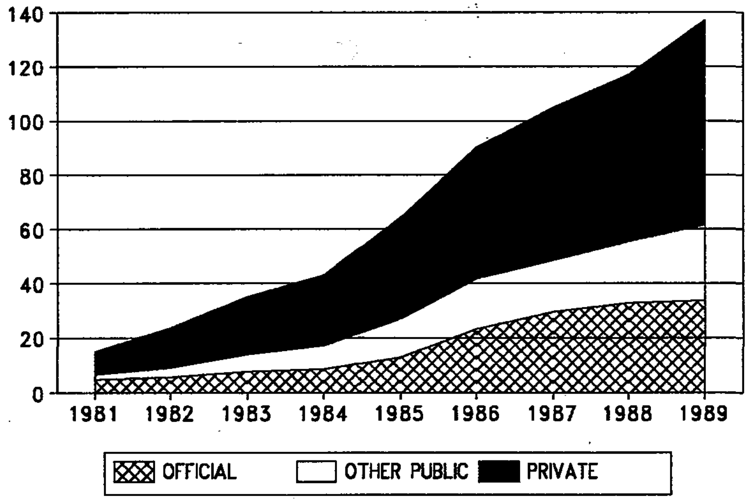


Figure 4 illustrates the magnitude of foreign debt relative to Australia's total exports (merchandise and services). It will be evident that gross external debt rose from around 75 per cent of export receipts to be near 280 per cent by June 1989; the corresponding figures for net debt are 40 per cent and 200 per cent.

Figure 5 shows the breakdown of gross foreign debt into official, "other public" and private debt. The Figure shows that official (Commonwealth and State Government) debt rose from some $5 billion in 1981 to about $35 billion in 1989. However the official share was significantly lower in 1989 than 1981, having declined from some 40 per cent to 25 per cent. By 1989, the **net** official debt (ie gross debt less, mainly reserve, assets) was actually only slightly more than 10 per cent

FIGURE 5: COMPOSITION OF GROSS EXTERNAL DEBT ($A BILLION)



of aggregate net debt (the Commonwealth Government actually became a net lender during 1989). The "other public" (government authorities and public sector business enterprises) gross debt increased by just over $25 billion, to form roughly double its 1981 share in 1989. By far the largest increase was posted by the private sector, whose debt increased by nearly $70 billion between 1981 and 1989. In **net** terms, the private sector is now actually responsible for around 65 to 70 per cent of Australia's foreign debt.[3]

3 ABS, (1989d). The Commonwealth Government had a surplus of $2.6 billion at June 1989 (excess of reserve assets over foreign borrowings), compared with State Government net debt of the order $16 billion. Available data on the net debt do not distinguish between the public (nonofficial) and the private sectors. The precise figure for private net debt therefore depends on how the non-official foreign assets are distributed between the private and public sectors.

FIGURE 6: INTERNATIONAL COMPARISONS OF EXTERNAL DEBT (% OF GDP)

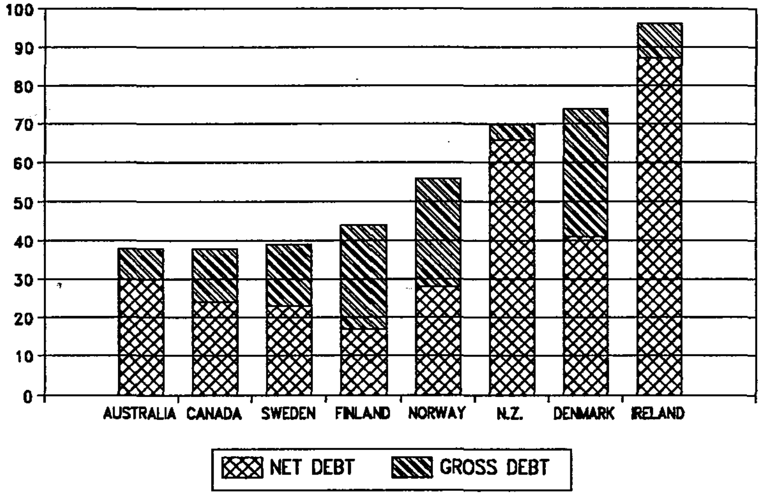


Figure 6 displays the ratio of both net and gross debt to GDP (based on 1987 data) for a selected group of developed countries. This chart indicates that Australia's foreign debt levels have been paralleled by Canada, New Zealand and several of the smaller European nations.

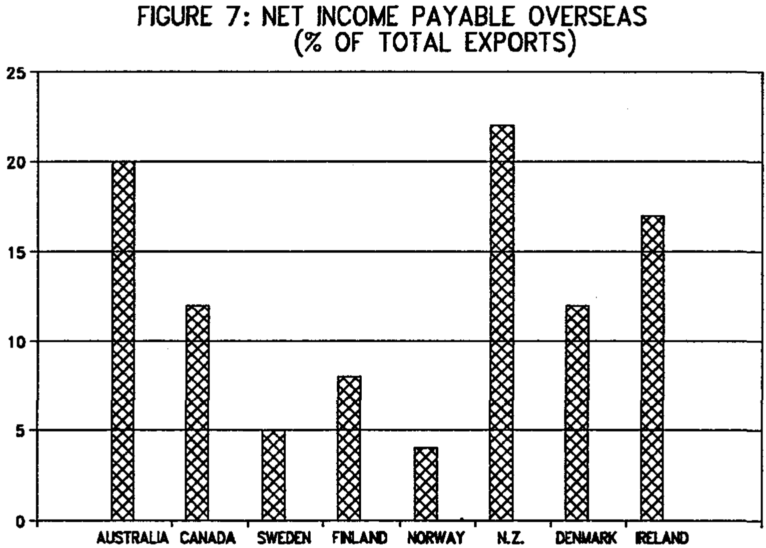


Figure 7 shows the ratio of net income payable overseas (including on equities) to total exports for the same group of countries. This chart indicates that Australia's debt burden relative to export performance is amongst the worst of these countries; only New Zealand has a higher ratio.[4]

To sum up, by every devisable yardstick, domestic or international, the last decade has seen a substantial increase in Australia's foreign debt. Debt (whether gross or net) has risen rapidly in absolute terms, and as a proportion of GDP and export earnings. Interest payments on this debt have escalated and this has impacted severely on the current account.

The volume of literature devoted to discussing the causes of foreign debt escalation is substantial. The most frequently cited explanations for this phenomenon include:

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4 However the investment opportunities generated by Australia's rich and diverse resource base does separate her from most of these nations. On this see Tamaschke (1988, 1990).

- The collapse in the terms of trade up to 1987.
- The valuation effects resulting from the Australian dollar's devaluation up to 1987.
- The impact of the "twin deficits" (ie federal budget and current account of the balance of payments) which existed for much of the 1980's.
- Australia's rigid industrial structure.
- The trend away from equity financing of investment throughout the 1980's.
- The strength of domestic demand following the recovery in the terms of trade after 1987.
- A decline in private savings.
- A taxation system which favoured debt financing.

Without wishing to dismiss the significance of these explanations, the remainder of this paper considers the impact of financial deregulation on the growth of Australia's foreign debt.[5]

The Financial Sector: Composition and Funding Behaviour during the 1980's

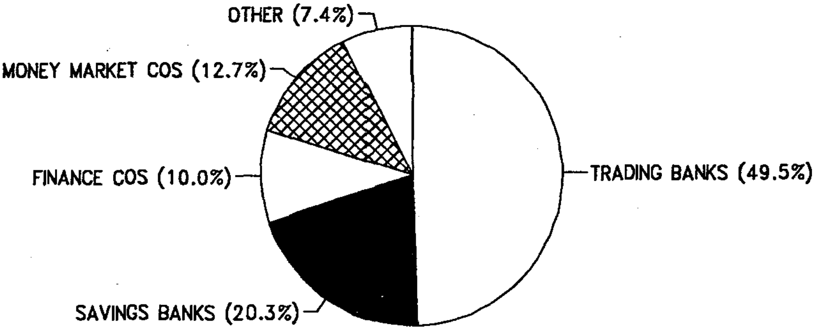
There can be little doubt that deregulation has created a more competitive environment for financial intermediaries in Australia. Figure 8 (which refers to June 1989) shows that the banks control by far the largest share of the financial sector's assets.

With deregulation, banks had been transformed into aggressive marketers of credit, free of most of the restrictive borrowing and lending limitations of previous years. Banks became more flexible in their methods of financing their asset base and the means of funding could now be adjusted in accordance with the relative cost of the

5 The references cited at the end of this paper discuss the 'traditional' explanations in detail.

available sources of finance at any point in time, both in Australia and overseas.[6]

FIGURE 8: PERCENTAGE SHARES OF ASSETS
AUSTRALIAN FINANCIAL SECTOR



A major reason for the increased competition in the financial sector was due to the activities of the new foreign banks, some of which also had subsidiaries in the non-bank financial sector. The influence of these banks was felt even before the first of them opened for business in 1985. The established banks were given adequate notice of the impending arrival of the overseas banks and prepared themselves through mergers and improved services. Meanwhile the new banks acted quickly to make inroads into the Australian market. All existing institutions had to work hard to maintain market share and profitability in the face of increasing competition.[7]

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6 See RBA *Bulletin* (1990a, 1990b, 1987a.) for some general background information.

7 On this see RBA (1987a, 1990a). It follows that the meaning of terms such as "increasing competition" and "more competitive" need to be qualified. While the entry of the new banks made the **structure** of banking more competitive, the bank merger activity associated with deregulation worked in the opposite direction; as a result of mergers, Australia was left with only four major domestic banks (the ANZ, Commonwealth, National Australia and Westpac, formerly Bank of New South Wales). At the same time the conduct of banking became more competitive

FIGURE 9: PERCENTAGE SHARES OF ASSETS AUSTRALIAN BANKS

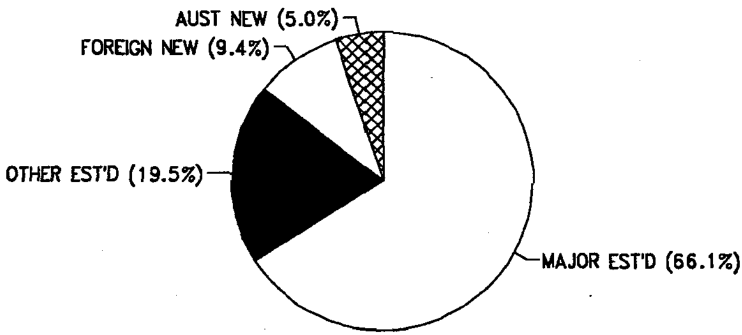

Figure 9 provides details of the composition of total bank assets on the Australian books as of September 1989, when the foreign banks had slightly more than a 9 per cent share; this share had been much the same since 1987. The combined share of the new banks (foreign and Australian) was just over 14 per cent of bank assets.

Not surprisingly, the new banks have encountered substantial difficulties in establishing wide deposit bases because the established banks were well entrenched with their extensive branch networks. As a result, the new foreign banks have had to rely more heavily on foreign currency borrowings and bill acceptances than the established banks.[8]

(through more frenetic advertising, different loan packages, some interest rate competition etc.).

8 On this see RBA (1987a), which provides details of assets of all trading and savings banks "on the Australian books" at the end of June 1987. Unfortunately, the major sources of financial data do not publish sufficient information on a regular basis to provide a detailed breakdown of foreign bank funding practises and asset structures through time.

The impact of deregulation is reflected in the increased size of the trading banks' foreign currency balance sheets, as illustrated in Figures 10 and 11.

FIGURE 10:TRADING BANK FOREIGN CURRENCY ASSETS & LIABILITIES ($A BILLION)

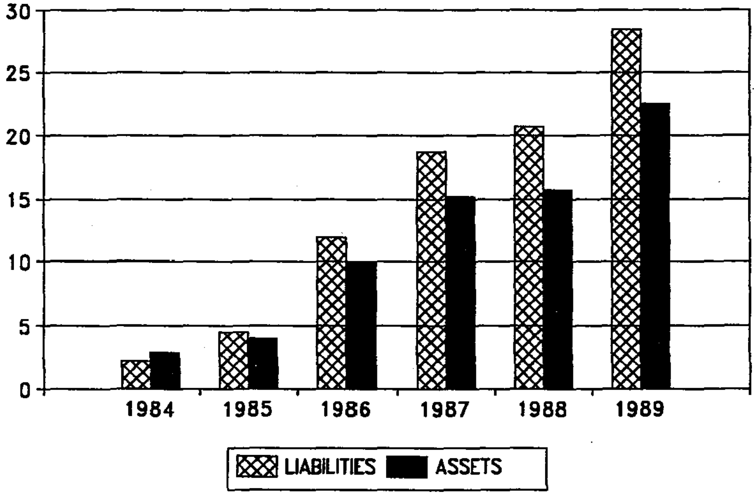

Figure 10 shows that the trading banks had foreign currency liabilities in excess of $28 billion in June 1989, compared with only about $2 billion in (October) 1984; over the same period foreign currency assets increased from around $3 billion to slightly more than $22 billion. This financing avenue, which was restricted prior to deregulation, accounted for about 20 per cent of Australia's gross foreign debt in 1989; the comparable bank share in gross debt was of the order of only 5 per cent in 1984. In 1989 foreign currency liabilities formed nearly 14 per cent of trading bank assets.[9]

9 The four major Australian banks have actually been amongst the 20 largest foreign exchange dealers in the world. Before the removal of the SRD requirement (on Australian funds) in September 1988, there was obviously an advantage to the banks from borrowing abroad.

FIGURE 11:TRADING BANK FOREIGN HOLDINGS WITH NON-RESIDENTS ($A BILLION)

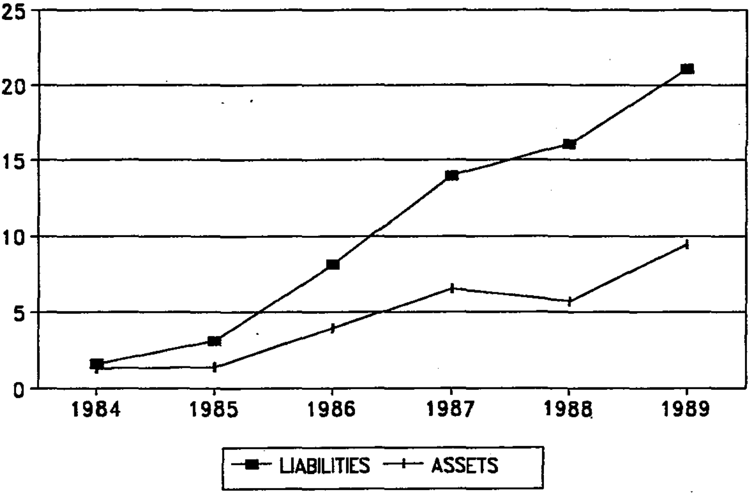

Figure 11 focuses on the composition of foreign currency transactions with non-residents. The Chart shows that **net** foreign currency liabilities with non--residents amounted to nearly $12 billion in 1989, compared with less than $0.5 billion in 1984. Part of this debt was incurred by the new foreign banks, whose debt share was substantially more than their 9 per cent or so asset share would suggest. A comparison of Figures 10 and 11 also suggests that the trading banks' net foreign currency loans to residents increased substantially over the period.

The above examination of the trading banks' balance sheets highlights only one of the ways in which the trading banks' activities could have been linked to foreign debt. These banks also conducted substantial off balance sheet business (ie contingent liabilities, commitments and market related transactions). The off balance sheet activities grew rapidly with deregulation and are estimated to form about three times the aggregate balance sheet totals. In September 1989, the foreign banks' off balance sheet business share was estimated to be about 22 per cent (compared with an asset base of slightly more than 9 per cent of total bank assets).[10] The foreign liabilities associated with the trading banks' off balance sheet activities are necessarily a matter for conjecture. If the off balance sheet foreign liability shares were anywhere near those of the balance sheet business, then net foreign liabilities associated with off balance sheet activity would obviously be considerable.

Another noticeable feature of the financial sector of the 1980's was the rapid growth in the number of money market corporations (commonly referred to as merchant banks); these increased more than threefold between 1983 and 1988. As of June 1989, they had borrowed more than $16 billion from nonresident sources, which amounted to around 30 per cent of their assets. If, in addition to the money market corporations, we include the liabilities of various finance companies, and general financiers, the total foreign borrowing of the so called "non-bank financial corporations" amounted to nearly $21.5 billion, or about 15 per cent of assets. The corresponding figures for June 1984 were nearly $3 billion and less than 5 per cent.

The combined overseas assets of the non-bank financial corporations were comparatively low, so much so that their net foreign liabilities are likely to have been not far short of $20 billion in June 1989. These estimates make no provisions for the off balance sheet activities conducted by non-bank financial corporations.

At the end of June 1987, foreign banks controlled about 18 per cent of the total assets of money market corporations and 14 per cent of finance companies. At this time the aggregate size of their subsidiaries averaged about 60 per cent of the banks themselves. In addition, although many of the new banks have capital resources which are small relative to the size of the loans sought by large corporate clients, in some cases they have "transferred" portion of the risk to their parent banks.[11]

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10 "Market related transactions" covers foreign exchange, interest rate and other market related transactions. On offbalance sheet business see RBA (1990b).

11 They also have interests in other nonbank financial institutions, including funds management, stockbroking and securities and futures trading. Overseas borrowing formed about 25 per cent of money market corporation liabilities in June 1988. On this see RBA (1987a) and Linklater (1989).

Thus the new foreign banks were responsible for a significant part of the external debt, either directly or indirectly.[12] Their influence went well beyond banking and they provided much more competition (through off balance sheet activity and in the non-bank financial sector) than their 9 per cent or so share of bank assets would suggest.

Overall, the net foreign debt liabilities of "financial enterprises" exceeded 11 per cent of GDP in 1989, which translates to more than 35 per cent of Australia's net foreign debt; in 1983 (ie before the floating of the Australian dollar, the lifting of exchange controls, and the proliferation of financial intermediaries), the corresponding percentages were around 2 per cent (of GDP) and around 15 per cent (of net foreign debt). In addition, it is likely that Australian financial enterprises were involved in the intermediation of net external debt incurred by the other sectors of the economy, through off balance sheet activities and through the part "transfer" of risks of large corporate loans to parent banks overseas; in 1989 the net foreign debt liabilities of "private trading enterprises" for example, exceeded 13 per cent of GDP, or an additional 40 per cent of the net foreign debt.[13]

Thus, a substantial part of the net foreign debt was incurred or negotiated by Australian financial institutions to provide credit for borrowers within Australia as the established and new banks (as well as the non-bank financial sector) fought for market share. Deregulation meant that Australia became more closely integrated into world financial markets, thereby facilitating foreign borrowing and, in so doing, adding to Australia's foreign debt.

Trends in Credit Structures

So far we have examined changes in the funding techniques employed by financial institutions during the 1980's. However of equal

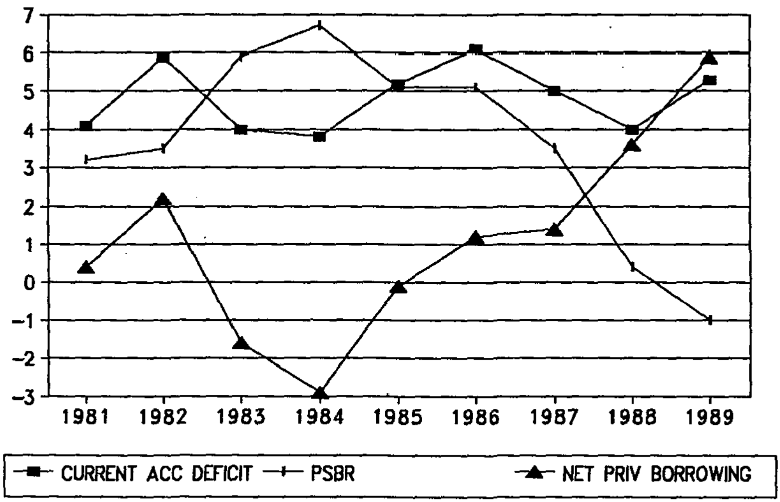
12 The Brisbane Courier Mail (1989b), went so far as to write "And the debt began to boom when new banks started here writing new, perhaps risky business."

13 Financial enterprises include private and public enterprises. On this see EPAC (1990) and ABS (1988/89e).

importance for these organisations is the asset side of their balance sheets. We now turn to the changes that have occurred in debt levels held by households, private corporate groups and the public sector.

The relationship between net private borrowing, the net public sector borrowing requirement (PSBR) and the current account deficit during the 1980's is found in Figure 12. This chart shows that net borrowing by the private sector has increased substantially over the last decade relative to both GDP and the current account deficit, with a sustained upswing since 1984.[14] The PSBR dropped from 1984 and became negative in 1989 as the Federal Government progressively reduced its budget deficits and moved into surplus. The chart shows that, rather than lowering the current account deficit and foreign debt, the reduction in the PSBR was offset by an increase in net borrowing by the private sector.

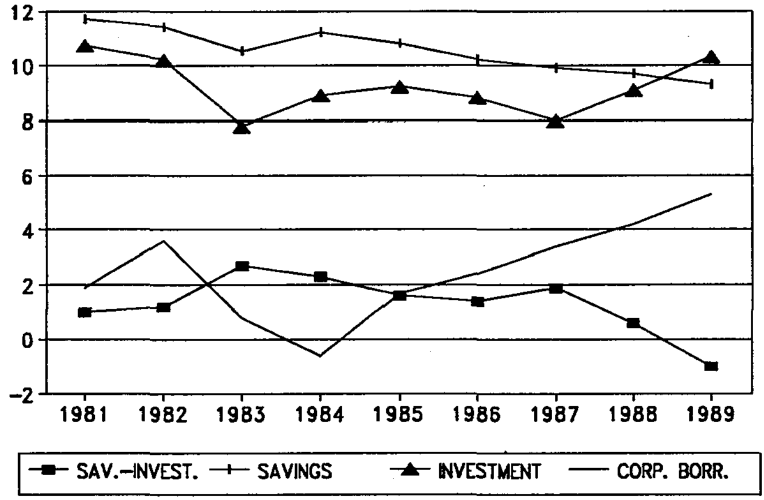
FIGURE 12:CURRENT ACCOUNT DEFICIT, PSBR AND NET PRIVATE BORROWING (% GDP)



14 Net private borrowing is estimated as the difference between total domestic overseas borrowing and the net PSBR.

Figure 13 shows the levels of savings (bank deposits, superannuation, bonds, shares etc.) and investment (new dwellings, unincorporated business plant and equipment etc.) by the household sector as a proportion of GDP[15]. The chart reveals that net household savings (in the sense of savings less investment) as a percentage of GDP decreased fairly steadily from 1983 and that the household sector actually became a net borrower in 1989. Thus by implication, the upward movement in net private borrowing after 1984 (displayed in Figure 12) was dominated by increased borrowing by the private corporate sector. Figure 13 shows the series obtained when the above net household savings series is added to net private borrowing. This series increases rapidly after 1984.

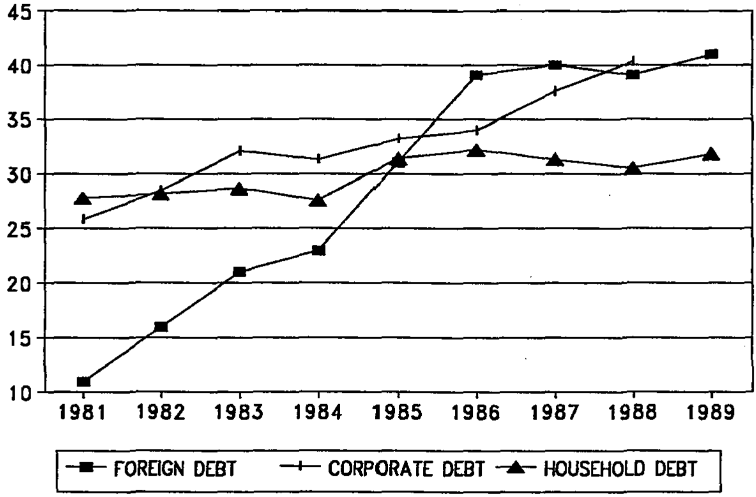
FIGURE 13:HOUSEHOLD SAVING & INVESTMENT
PER CENT OF GDP



15 The investment/saving behaviour of households is particularly significant as the household sector has traditionally been a net provider of funds to both the government and corporate sectors.

Figure 14 compares the growth of the gross external debt with private corporate debt[16] and household debt. This figure shows that the corporate debt to GDP ratio increased by around 14 per cent, from a little more than 25 per cent of GDP in 1981 to about 40 per cent in 1988; more than half of this increase was between 1984 and 1988.[17] Household debt appears to have plateaued in recent years with most of the decade's increase occurring between 1984 and 1986. The increase in household debt through the 1980's amounted to about 4 per cent of GDP. Overall, the private sector debt increased by some 18 per cent, most of it in the corporate sector.

FIGURE 14: CATEGORIES OF GROSS DEBT (PER CENT OF GDP)



Thus, whether we take corporate debt or borrowing (both per cent of GDP) as a yardstick, the private corporate sector substantially increased its debt during the 1980's. The debt/equity ratios of Australia's 30 largest listed non-finance industrial companies actually increased from

16 Following standard practice, public financial enterprises are included as private because they perform essentially the same functions as private financial enterprises. On this see EPAC (1990).

17 Data for 1989 were not available at the time of writing.

around 50 per cent in 1980 to almost 70 per cent in 1989 and interest cover (the number of times that pre-tax, pre-interest profit covers interest costs) declined from just under 5 to 3 over the same period.[18] Corporate expansion during the 1980's has therefore shown an increasing willingness to rely on debt financing at the expense of equity raising, which is consistent with the trend in Australia's external liabilities (Figure 3). Obviously, borrowing also requires the consent of lenders, so that the tendency towards increased debt financing must have met with the approval of financial intermediaries, who were increasingly competing for market share as deregulation progressed (with the aid of foreign funds).

FIGURE 15: PRIVATE INVESTMENT % OF GDP
CURRENT AND 84/85 PRICES, T/T ADJUSTED

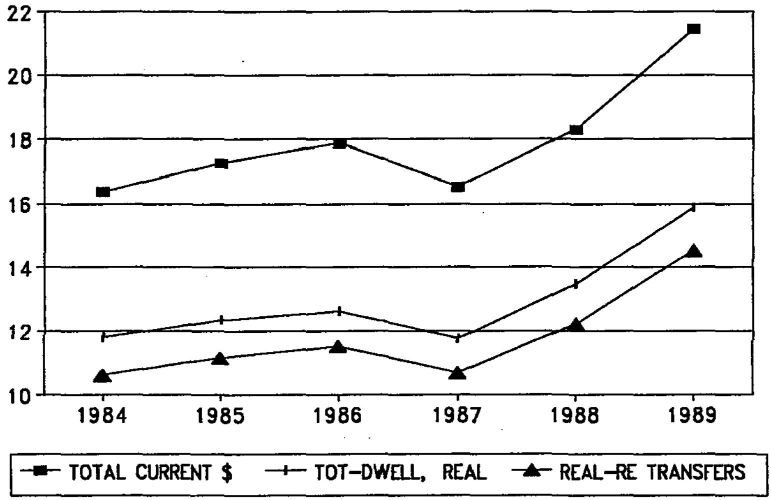


Figure 15 displays gross private investment as a percentage of GDP from 1984. The top series examines total private investment (including stock changes) in current prices. The remaining series attempt to focus more closely on real corporate investment. The series are at 1984/85 prices (corrected for changes in the terms of trade) and exclude

18 *Courier Mail* (1989a).

dwellings (the middle series) and both dwellings and real estate transfers (the lower series).

Inspection of the preceding Figures would seem to suggest that between June 1984 and June 1987, real gross corporate investment (per cent of GDP) was fairly constant (the 1987 level was almost the same as in 1984), while the corresponding percentages for gross corporate debt (Figure 14) and borrowing (Figures 12 and 13) and foreign liabilities expanded significantly. This was the period following the floating of the dollar and the lifting of exchange controls, and when new and established financial intermediaries operating in Australia were increasingly fighting for market share.

While successive devaluations of the Australian dollar may have caused some valuation effects on debt levels during this time, corporate borrowing and debt actually increased substantially in 1987 as the exchange rate[19] was bottoming out, and as both the investment/GDP ratio and the PSBR declined. Also, Figure 11 shows that the banks' net debt liabilities with foreigners were almost zero in 1984 and that the changing relativities between liabilities and assets must therefore have been more than just a valuation effect.[20]

All up, the evidence presented in this paper would seem to support the view that private corporations obtained some foreign-financed loans, which did not lead to increased investment. The period in question is of course the one leading up to the stock market 'correction' of 1987, when there had been substantial takeover and other speculative activity. This does not appear the case after 1987, when the terms of trade recovered and rising corporate and foreign debt levels appear to have been more closely associated with increased investment.[21]

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19 Represented by the trade weighted index and the $US exchange rate as of 30th June each year.

20 In fact data in ABS (1988/89e) suggest that the effects of exchange rate variations on debt in 1987 could actually have been negative, not positive. About 30 per cent of the foreign debt was actually denominated in Australian dollars at this time.

21 However, further research may be warranted into the composition of "equipment" and "nondwelling construction" to shed light on the nature of investment during the period.

Specific data that dissect the flow of foreign debt to the corporate sector are necessarily tenuous. Nevertheless, it can be illuminating to examine individual company reports depending on the extent of disclosure contained in the particular report. For example, the 1988 Bond Corporation Annual Report indicates that total Creditors and Borrowings were $5.7 billion. Of this amount, $3.2 billion was denominated in foreign currencies and a further $600 million of liabilities was Australian dollar denominated, but raised abroad (this amount may have been substantially greater as most of the remaining debt instruments were not detailed). If it assumed that all foreign currency loans were from non-residents, then almost 70 per cent of Bond Corporations debt was, in 1988, external.

A similar pattern is revealed from an examination of press reports concerning the liquidation of both Hooker Corporation and the Qintex Group. Hooker went into receivership with debts of $2 billion spread amongst 62 banks. Detailed information was only provided on the $767 million debt owed to Hooker's major creditors, but $392 million (51 per cent) of this debt was owed to foreign banks.[22] With Qintex the identification of creditors for $1.2 billion out of a total debt of $1.4 billion was revealed. Foreign banks accounted for $775 million (64 per cent) of the identified debt.[23] As the private sector is currently responsible for the lion's share of foreign debt, the heavy reliance on external borrowing suggested by the above cases could well characterise other Australian companies.

To sum up, although the PSBR declined, other debt levels in Australia increased rapidly through the 1980's, especially in the corporate sector. Intense competition for market share between financial intermediaries appears to have facilitated this process with the aid of substantial borrowing abroad.

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22 *AFR* (1989b)

23 *AFR* (1989a). While these liquidations have the potential to cause substantial losses for overseas creditors, in a statistical sense, they could actually "help" the overall problem of the foreign debt.

Conclusions

The last decade has seen an almost complete deregulation of Australia's financial markets, with the dismantling of regulatory controls. Overall, this has led to a much more competitive environment for financial intermediation.

The analysis of this paper suggests that financial deregulation (including the floating of the dollar and the lifting of foreign exchange controls from December 1983) undoubtedly facilitated the flow of foreign funds for investment projects as the Australian financial sector became more fully integrated into world financial markets. Obviously, the process of borrowing abroad for investment purposes had to add to Australia's net foreign debt.

However, there would also seem to be some evidence of lending to the corporate sector which did not lead to increased investment. This appears particularly evident for the period leading up to the stock market "correction" of October 1987, when takeover and other speculative activity was prevalent and the new and established financial intermediaries were competing for market share.

Financial deregulation should therefore be included amongst the important causes of foreign debt escalation in Australia during the 1980's.

Data Sources

Data sources on which the Figures are based are as follows:

Figures 1 to 7, 10 and 11: RBA (1990b, 1989a, 1988), ABS(1988/89a, 1989d, 1988/89e), Treasury (1989) and EPAC (1989c).

Figures 9 and 10: RBA (1990b). The assets of State Banks are included.

Figures 12 to 15: EPAC (1989a), Commonwealth of Australia (1988/89), ABS (1989a,1989b). RBA (1990A,1987b).

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