FINANCIAL DEREGULATION IN RETROSPECT

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It has now been five years since the last policy actions were taken to deregulate the financial system. Whilst it is perhaps too early to make any definitive judgements about the impact of deregulation, several developments nevertheless seem to be emerging which strongly suggest sectoral private interests have come to benefit more and more at the expense of wider public and private interests. To demonstrate and support this contention I have chosen to combine the broader expectations of deregulation with the official rationales that underpinned the overall policy package that effected financial deregulation. I shall then go on to assess these expectations and rationales against current realities. Based on the following evidence, it will become clear that various interests which moves to deregulate the financial system were supposed to serve have been ill-served and that re-regulation of some parts of the financial sector may be necessary if a more equitable and efficient system is to ultimately emerge.

The following might be considered a general compilation of those interests which the array of deregulatory policies that came into operation between 1979 and 1985 were expected to serve and the way in which they were expected to do. Firstly, the relaxation and in some cases abolition of controls on bank interest rates and asset-ratios were expected to re-establish the banking sector's competitiveness and viability as a clearing house for overseas domestic funds. It was generally hoped that funds for housing, small business and, in particular, for the restructuring and re-equipment of Australian industry would become easier. Secondly, the licensing of new retail banks (including foreign banks) was expected to increase the competitiveness and efficiency of the financial system in general, to give residents of Australia greater access to world-wide financial services, and thereby to provide a wider range of cheap financial services for domestic consumers. Thirdly, the marketing of government securities on a free-market basis was expected to better assist the financing

of public debt and social overheads. Fourthly, the floating of the exchange rate, the removal of exchange controls, and the entry of new foreign exchange dealers were allowed to occur in the expectation that these actions would help correct Australia's current account imbalance, stop inflows of speculative foreign funds and stabilise exchange rates. And finally, the combination of all these was expected, first, to make the management of the total financial system more effective and thereby help to promote financial stability and equity, and, second, to help finance the restructuring of the Australian economy away from its traditional reliance on primary commodity exports towards a more export-orientated and import-substituting manufacturing base.[1]

To begin with, there can be little doubt that deregulation has increased the availability and range of financial services and products. Whilst the reasons for this outcome lie considerably with the opening of the domestic financial market to overseas lines of credit and increased competitiveness (points which will be addressed in more detail below), the outcome can also be attributed to the improved financial position of the banks. The latest available figures show that, for June 1988, the banks accounted for about 42 per cent of financial assets, compared with 38.9 per cent ten years earlier (see Table 1). Some of this movement occurred because some non-banks became banks. However, it could also be said to have occured because banks took over specialist activities of the non-bank part of the system. For example, the recent report that both the Commonwealth Bank and the Australian and New Zealand Banking Corporation (ANZ) have experienced a 20 per cent increase in superannuation business, and Westpac Corporation's reputed $100 million worth of life insurance business, are indicative of how the banks have been able to capture a significant share of markets in services formally the province of non-banks (Brewster 1990:35).

1 This list is by no means exhaustive; and it should be noted that a number of unstated linkages exist between each policy action and expected outcome. For a relatively succinct overview see Hall 1987:passim. As many of the Campbell Committee's recommendations were subsequently implemented, it is also worthwhile referring to the report of the Campbell Committee's inquiry. (Campbell Committee 1981). The list also owes something to one outlined by Stretton (1989:19).

Table 1: Assets held by Financial Institutions (per cent)

	1965	1970	1975	1978	1988
Banks	46.2	42.7	42.0	38.9	42.0
Non-Banks	53.8	57.3	58.0	61.1	58.0

(a) Excludes Reserve Bank assets.

Source: B.L.Hamley 1979:17,24-5; Australian Bankers Association (nd) table 1; National Australia Bank 1989:2

The re-emergence of the banks as a competitive financial power has given them much greater liquidity. The greater availability of housing finance, for instance, is often represented as one of the most beneficial results of deregulation. Whereas in 1978 $13 billion (in 1988 dollars) was provided for housing finance in the form of 254,000 loans, in 1988 finance for housing by all providers amounted to over $23 billion and covered 393,000 individual loans (Brewster 1990:35). Undoubtedly the community's access to a greater range of financial services and products has been significantly enhanced by bank deregulation, and, if anything, the banks have come under increasing criticism for over-selling consumer debt.

On the other hand, the greater volume of funds is only available at high interest rates. Consider some of the findings in Hugh Stretton's analysis of the effects of the currently high rates of 'real' interest (the real interest rate being the difference between the nominal rate of interest and the rate of inflation over the life of any loan). Stretton estimated that, prior to regulation, real interest rates on loans for housing or government averaged less than 1 per cent between 1945 and 1980, whereas in 1989 this had risen to 8 per cent (see Table 2). In practical terms, this meant that if $50,000 (in constant dollars) had been borrowed to purchase a house before deregulation, and repaid (at a fixed interest rate) over 20 years, it would have cost altogether about $55,000, whereas at the current level of

real interest rates it would cost about $85,000. For government borrowings the position is even worse because loans are constantly being turned over. At 1 per cent 'real' before deregulation, each billion dollars of new public borrowing added about $10 million (in constant dollars) to the government's annual interest bill. At current rates, Stretton has calculated that it would add upwards of $80 million (Stretton 1989:19).

Table 2: Average Real Interest Rates (%) 1950-59 to 1985-89

Year	Nominal Overdraft Rate (a)	Consumer Price Index	Real Interest Rate
	1	2	3=1-2
1950-59	5.0	6.8	-1.8
1960-69	6.3	2.4	3.7
1970-79	9.5	9.5	0.0
1980-85	15.5	9.0	6.5
1985-89	18.0	8.2	9.8
1945-80	6.9	6.2	0.7
1980-89	16.7	8.6	8.1

(a) Average 'prime' and 'small overdraft' interest rates of major trading banks.

Source: Australia, Department of Treasury (1990:35); M.K.Lewis and R.H.Wallace (1985)

It seems reasonable to expect from this that, although finance has become more readily available because of deregulation, home buyers and other small borrowers must have been put at a severe disadvantage by the rise in real interest rates. It further seems likely that those who benefit from investment will suffer in the longer-term with the running down of public services and curtailment of new works, as the ratio of interest repayments to revenue grows (assuming current 'real' interest rate differentials persist). Moreover, it is also worthwhile noting that some producers using borrowed funds will pass on the higher interest rates in price rises, just as highly-geared landlords will build them into their rents.

The recent reign of high interest rates is directly related to the lowering of previous controls on interest rate ceilings. It is also a manifestation of the greater level of integration that has occurred between the domestic and international financial markets since deregulation. More specifically,

the entry of new foreign banks and the lowering of controls on external transactions has enabled large amounts of overseas capital to flow into and out of the country at will. In other words, there is another side to the coin of encouraging greater capital inflow to finance the expansion and diversification of the country's exports, to manufactured exports in particular.[3]

Regrettably, while the capital inflow has financed growth of total product, there has been an insufficient growth of export revenue to service the overseas funds flowing into the country. As a result, the Federal Government has sought to maintain high interest rates in the hope of curtailing domestic demand for *imports*. The irony is that high domestic interest rates also have the tendency to attract higher levels of foreign investment. And whilst this has been useful in funding the prevailing trade deficit and pre-existing overseas debt, it does contribute to the current account problem in so far as significant portions of it only every find their way into speculative activities such as in real estate, takeovers, etc.

Naturally, this seemingly circular problem would be overcome in the longer-term if the prices of Australia's traditional exports turned significantly upwards, or there emerged a stronger, more export-oriented manufacturing sector able to earn enough revenue to compensate for the in-flow of overseas investment. Whilst the first of these remedies seems unlikely to occur,[4] and at any rate is largely in the hands of world-wide commodity brokers, the second seems equally unlikely despite the fact that one of the primary rationales for deregulation was the potential it seemingly offered for financing the development of a stronger manufacturing export sector. Consider for a moment the fact that Australia's growing current account problem is not so much a problem of a growing deficit in merchandise trade as a problem of the growing deficit in services (including 'the services of capital'). This has clearly stemmed from the greater level of integration that has occurred between domestic and international financial systems since deregulation. With little or no

3 Based on statements made by Paul Keating (Byrne 1986:12)

4 I believe there is sufficient evidence suggesting that the long-term global trend is running against tradeable commodities relative to value-added manufactured goods. Without going into the specific details of this phenomenon, it is possible to say that, on a base of 100=1909-13, the index of Australia's terms of trade has steadily declined from c.1500 in 1950 to c.550 in 1985 (Chapman 1989:24).

foreign exchange control, Australian businesses now have greater access to overseas finance because the entry of foreign banks has opened lines of overseas credit, so much so that, where Australia's net external debt was around $10 billion (1980) prior to deregulation, it is now running at over $110 billion, of which the private sector is carrying some $70 billion. If the in-flow of funds were being used to improve the productive capacity of the country, and in particular of those industries able to earn off-setting export revenue, deregulation might indeed improve the balance of payments situation.

This has not been the case to date. Part of the reason is that high interest rates have channelled funds from both domestic and international sources into portfolio rather than into more direct investment;[5] and as will be seen below, the former are more speculative. One particularly unproductive outcome of this orientation of funds since deregulation has been a rise in the number of corporate takeovers. Whereas in 1984, slightly less than $2 billion was spent in Australia on takeovers, by 1987 this figure was estimated to have jumped to over $8.5 billion (Byrne 1986:12).

The problems associated with the deployment of overseas investment and the high level of external debt this has bestowed upon Australia, the uncertain control of domestic inflation rates, and a floating exchange rate have together conditioned foreign lenders to now charge Australian borrowers higher rates for funds than might have been necessary had the financial system not been deregulated (Stretton 1989:19 and Bryan 1989:70). Although 80 per cent more of domestic lending is from one Australian to another, all Australians must nevertheless now pay the rates foreign lenders demand for the 15 to 20 percent which they contribute to Australia's aggregate borrowing needs.

Let me return to the earlier proposition that deregulation has made returns on investment in speculative activities increasingly more attractive than returns on investment in productive activities. As has previously been noted, deregulation has brought in its wake an increased level of competitiveness within the financial system. Trading within the financial system

5 For example, Total Direct Foreign Investment grew by 11.3% p.a. over 1982-1987, whereas Total Portfolio and Other Foreign Investment grew by 27.4% p.a. over the same period. Total Foreign Investment in manufacturing (direct, portfolio, etc.) grew by 13.9% p.a. over 1982-87, where T.F.I. in Finance, Property and Business Services grew by 25.6% p.a. (Australia, ABS 1988:31).

has, in consequence, moved away from longer-term, lower-yielding but riskier securities. Some analysts have surmised that on average, the newer and smaller financial institutions with limited capital resources depend for as much as 50 per cent of their incomes on speculative gains rather than interest yield. They have similarly found that the bigger and more established banks have also become more reliant on speculative trading activities to boost their profits, and that this has been at the expense of more productive forms of investment (Tingle 1986:34). All forms of investment are speculative, of course; but for some capital gain is expected to be much larger in relation to interest yield than for others. Some sort of evidence of the importance of speculation can be got from the high rates of turnover of specific securities. For example, between January and October 1986, the turnover of trade on 90-day bank-accepted bills, with a face value of just $10.4 billion, was over $215 billion. Similarly, the turnover of trade on 10-year Treasury Bonds valued at $629 million over the same period was $13 billion. The foreign exchange market is another notable area of speculative dealings. For example, in 1986 alone, the annual turnover of foreign exchange transactions was over $3000 billion - generated from the export and import of goods and services worth only $150 billion. (Tingle 1986:33,35) Further, evidence of the speculative nature of foreign investment could be said to exist in the fact that approximately 30 per cent of Australia's $137 million foreign debt is short term, repayable in 12 months, as opposed to only 15 per cent a decade ago (Korporaal 1990:24). These and other such transactions generally bear little relation to the underlying tangible stock being produced or traded in the market-place.

Since deregulation, money market dealers are no longer confined to the domestic market only. With little or no exchange controls on the movement of capital in and out of the country, financial institutions seeking a competitive edge are beginning to 'park' considerable portions of their funds in one of the world's overheated share-markets or proliferating tax havens. Some of Australia's major life insurance and superannuation offices, for example, are now investing as much as 50 per cent of their funds overseas (Byrne 1986:14). And whilst there is perhaps the prospect that returns on these investments may be beneficial to domestic policy holders in the future, the movement of these funds off-shore is clearly at the cost of improving the country's productive capacity.

Because financial institutions have become more speculative in their choice of securities, they have also become more liable to fail. The

Victorian State Bank's recent loss, arising out of the failure of it subsidiary, Tricontinental, is perhaps the most notable recent example of how financial institutions choosing speculative securities can put at risk the deposits of the wider community and, in this specific case, impose an unwarranted cost on the general tax-payer for many years to come. To take a further example, the stock market crash of 1987 bears obvious witness to the rising state of financial instability associated with the increasing levels of speculation largely unconnected with the levels of real productive economic activity.

It seems reasonable to suppose that greater competition has occurred since deregulation. However this has been at the expense of the stability that prevailed under the old regulatory regime. Moreover, it is not clear that greater efficiency has emerged, given the high turnover of financial claims relative to the underlying quantity of goods and services actually traded. Such a high turnover must surely raise the costs of financial intermediation as well as swell the numbers employed in the financial industry as a whole.

The rise in speculative investment activity by financial institutions, together with a devalued dollar, high interest rates, and the greater access to overseas capital by corporate raiders have produced a siege mentality among many companies. Many now believe that if they are to survive in the longer-term, they must direct their investment more into acquiring existing capital assets rather than creating new ones. Chairman of the National Companies and Securities Commission, Henry Bosch, summarised the situation recently when he noted that:

> a management which feels under threat will divert part of its energies from the longer-term creation of wealth to defensive measures. Takeover bids directed at disrupting the calculations of predators are common. Defensive alliances, agreements, share placements and the like are frequent. Most serious of all, managements are tempted to maximise short-term profits and share prices by measures that undermine longer-term productivity and growth (Tingle 1986:34).

Bosch's observations seem born out by the defensive strategies now adopted by many companies who, in order to fend off potential take-overs, limit equity issues so as to increase dividend payments per share and reduce the volume of script that may fall into hostile hands. The same strategies generally also involve highly gearing the company, partly as a consequence of the attraction of tax deductibility of interest payments, but

also to fund their own takeover bids. It is therefore not surprising that the funding of takeovers has come to be primarily through debt.[6]

Table 3: Private New Capital Expenditure (% of total)

Year	Mining	Manufact.	Finance(a)	Other(b)
1982-3	24.6	29.1	16.2	30.1
1983-4	18.3	25.1	19.6	36.9
1984-5	14.5	26.5	22.9	36.2
1985-6	15.6	29.3	20.3	34.8
1986-7	17.2	30.0	20.5	32.4
1987-8	15.9	29.3	26.2	28.6
1988-9	13.4	27.6	30.2	28.8

(a) Finance, insurance, real estate and business services
(b) Public utilities, transport, wholesale trade and non-man. ind.
Source: Australia, Department of the Treasury 1990:17.

In an environment where it is better to be an investor-lender rather than a borrower-producer, the biggest gainers have been the dispensers of financial products and services. Next in line have been those larger corporate entities who have been able to negotiate significantly better interest rate terms in domestic financial markets because of the sheer volume of their loan requirements, and who in any case can afford to sustain loans because of the tax deductibility that is offered on interest repayments. Those corporate entities who have been able to tap directly into the international finance system have also gained, although in recent times some of these have had their fingers burnt as the dollar has moved lower against other currencies.

The greatest losers are the smaller buyers of financial products and services, such as farmers, home buyers and small businesses, who are price takers. To these losers are to be added those people who are not directly using financial services and products, but who pay higher costs

6 From a survey of 325 major listed public companies undertaken by Statex, it was found that the debt to equity ratio had increased by 40% between 1980 and 1985 (Toner 1988:51)

for some goods and services as a result of high interest repayments being built into prices. Finally, there are those who, despite the availability of finance, are simply squeezed out by the fact that they cannot afford the higher prices of the financial services and products on offer. At the same time, neither the farmer's protest rallies in 1988, nor the appeals of the Small Business Council, nor even the recent political reverses in the mortgage belt electorates, have moved the government to reassess the merits and failures of financial deregulation as it now stands.

The power of the Reserve Bank to regulate financial activity has also suffered. The Bank is still to demonstrate any sort of real control over inflation and the volatility of exchange rate movements. And to the extent that is has not, the scope for speculation has widened.

Why does the current government not take legislative action to correct the obvious failings of the present financial system? After all, the financial system is fundamentally important to the operation of a capitalist economy and to its legitimacy in the eyes of electors. In the post-war years leading up to the early 1970s, the diverse objectives of both the financial institutions and various governments of the day were generally being realised. Regulations effectively insulated Australian financial markets from wider external influences, which benefited the profitability of financial institutions as much as they helped to achieve for Menzies the economic and social outcomes he wanted. The commercial banks accepted increasing regulation as long as they were protected. From about the beginning of the 1970s, this protection came under increasing external pressures. Advances in international communications technologies in the business of financial intermediation started to emerge; a growing number of overseas non-bank institutions began to make their presence felt in Australian financial markets; and the failure of the Bretton Woods system of foreign exchange enabled domestic capital resources or their controllers to become more international than national in orientation. The former protection came to be seen as a source of inefficiencies; and in turn came to be seen as insupportable. Either the set of regulations had to be changed or there had to be deregulation. The basic problem with the first option was that it seemed impossible to design unilateral regulations that would not be circumvented easily or would not dissuade potential overseas lenders. By contrast, with deregulation not only were domestic capital resources expected to remain, but overseas capital was expected to be attracted to the country. The increased availability of capital could in turn be expected to enhance the prospect of economic growth, help create

conditions of social harmony, and thereby secure the political fortunes of the government involved. Thus with the growing prevalence and mobility of international capital movements, and the greater internationalisation of the business of financial intermediation, the more subordinate are governments likely to become and the weaker their capacities in economic management and the preservation of social harmony are likely to be.

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