FINANCIAL DEREGULATION: WHY DID COMPETITIVE MARKETS FAIL?

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Financial deregulation was presented to the Australian people by successive governments and their advisers as a necessary condition for a smoothly functioning market economy. However, the principal argument of the deregulators - that removal of bank controls would lead to more efficient financial markets, with leaner interest rate margins - have proved to be false.

The Australian experience of financial deregulation has demonstrated that an increase in levels of competition, in conditions of oligopoly led to a less efficient and more cartelised market. This gap between theory and experience requires some explanation. How did increased competition lead to a less efficient financial market?

This paper charts the broad outcomes of the deregulatory changes, and looks at the explanations for the unexpected outcomes by the orthodox supporters of financial deregulation. It focuses on the central issue of competitive efficiency, skimming over some of the important secondary debates such as the entry of foreign banks, stability of the currency and the effective average cost of housing finance.

The "competitive market system" spoken of by the proponents of deregulation is taken here to broadly follow the assumptions of the neoclassical conception of competition. "Efficiency" is also assessed in terms of the neoclassical view that a highly competitive market with freely adjusting prices will in turn adjust profit margins to a minimum.

Financial Deregulation: What Happened?

The champions of financial deregulation in the late 1970s and early 1980s argued that an abolition of banking controls would lead to a market of competitive efficiency, which would in turn create a series of benefits including:

- stable and lower interest rates,
- greater availability of funds,
- leaner margins between interest rates for borrowing and lending,
- innovations in service, and
- the broader beneficence of an efficient financial system to production.

The evidence following the mid 1980s comprehensively disproves almost all of these predictions. It is now clear that financial deregulation contributed to the development of a less efficient Australian banking system, as measured by the key macro outcomes, primarily increased margins between lending and borrowing, but also higher interest rates, greater foreign exchange instability, massive corporate borrowing for non-productive investment and billions of dollars in bad debt.

Certainly more foreign capital was drawn into Australian circulation, but while the Australian banks and some entrepreneurial corporations benefited, most did not. There were also regressive effects. For instance, before deregulation the cost of housing finance was held down and subsidised by other finance; whereas after deregulation the borrowers of funds for housing paid a premium for its supposed higher risk. Thus, along with consumer debt, housing finance has come to subsidise other more "upmarket" finance. To put it briefly, under deregulation more funds became available, but the price of those funds rose so steeply that only the money lenders and those already wealthy benefited.

The Arguments for Deregulation

Economic regulation in general had been ideologically cast as the bastion of bureaucratic or private interests, under the guise of social equity. By this argument, an unholy alliance of vested interest groups (eg. farmers seeking cheap loans or protected manufacturers unable to compete in the world market) and bureaucracies needing to justify their existence had connived at creating and maintaining a complex set of regulations. Such regulations were inimical to a general, theorised "free market" efficiency and equality of opportunity. As Pincus and Withers (1983: 45) put it, this argument has it that the 'public interest theory' of regulation was 'a straw man'.

It proved much easier in these circumstances to point to the supposed costs of financial regulation than to the benefits. The charge of 'throwing out the baby with the bathwater' could be easily ignored in the face of a new found 'free market' enthusiasm and an international body of capital impatient for the loosening of controls. Yet a revision or rationalisation of regulations was always a clear alternative to open deregulation. As Pincus and Withers (1983: 60) pointed out, "a casual glance at the more successful economies (eg. Japan, Germany, Singapore) does not show an absence of regulation - only seemingly more successful regulation". Policy makers in Australia did not seriously consider this option.

The domestic banks certainly wanted a chance to move into the areas that were increasingly being taken over by finance companies and merchant banks. They wanted deregulation and indeed were likely to be the major beneficiaries of it. Whereas they were apprehensive about the prospect of competition from foreign owned banks, they were confident their well-developed branch infrastructure would help them retain their market dominance and that the entry of the foreign banks would speed the removal of domestic controls. The very substantial resources of the banks were mustered to support the case for deregulation made by the first 'inquiry' into the Australian financial system, commissioned by the Fraser government in 1979 and led by the late Keith Campbell.

The banks' case for a more open market financial system was based largely on the grounds of fairness (to the banks) and supposed competitive efficiency. Thus the Bank of New South Wales (later Westpac) pointed to the banks bearing "an unequal portion of the burden" of regulation, compared to the Non-Banking Financial Institutions (NBFIs). Making it clear that "it is not our view that direct controls should be applied to others", it suggested that "a return to free market conditions" of the pre-1930s would both "strengthen the discipline on government expenditure" and ensure competitive efficiency in the market place (Bank of NSW 1979: 2, 118, 119, 123).

This argument was broadly accepted by the Campbell Report, which became a blueprint for extensive financial deregulation, predicated on the general belief that:

> the most efficient way to organise economic activity is through a competitive market system which is subject to a minimum of regulation and government intervention (Campbell 1981: 758).

The committee commissioned studies from economists and took lengthy submissions from parties concerned with the financial system, particularly the banks. It was encouraged in its beliefs by studies such as that of Swan and Harper (1982: 511), which suggested that deregulation would not only be what the banks wanted, but that there was the "possibility of sizeable welfare gains" particularly through such things as the "compression of the interest differential between deposits and loans" and the payment of interest on demand deposits.

Treasury's view cautioned the need for "some measure of regulation to provide adequate information to guide investor's decisions, to prevent abuses (whether arising from lack of prudence or criminal intent) and to achieve and sustain macroeconomic stability". However it joined in the strong critique of existing regulation by observing that regulation designed to correct market failure "often produces someone with a means of making money other than through innovation and the efficient production of goods and services" (Australian Treasury 1979: 29).

The Campbell committee recommended a radical deregulation of the entire financial sector: banking, finance, stock exchanges and foreign

exchange. Foremost amongst the 64 pages of summarised conclusions and recommendations were proposals for:

- the abolition of all controls over bank deposit and lending interest rates;
- a relaxation of required bank liquidity ratios;
- a market-determined exchange rate and a dismantling of exchange controls;
- a more open market sale of government bonds and securities;
- greater freedom of borrowing rights for semi-governmental authorities;
- deregulation of stockbroking;
- relaxed limits on individual shareholding in banks;
- an opening up to foreign owned banks; and
- several investor-oriented reforms in tax law (Campbell 1981: 758-822).

The Campbell Report justified these deregulatory moves by predicting that they would contribute to a generally more competitive financial sector, which would in turn reduce the interest rate margins of financial institutions, spur credit initiatives and so benefit users of the system. The supposed benefits of deregulation were set against the suggested costs of current regulation. Interest rate and lending controls diverted funds to "possibly less efficient intermediaries", while they also "blunted the competitive and innovative drive" of the banks. (Campbell 1981: 761)

In 1983 the newly elected Labor Government commissioned a review of the Campbell Report, led by Vic Martin. The Martin Report supported the deregulatory thrust of the Campbell Report, though without depending to the same degree on free market ideology. The Review Group claimed itself free from "general presumptions, derived from theoretical models, about the operations of unregulated markets", while adding that "market oriented policy .. [was] seen as having considerable

advantages". (Martin 1983: 361) The Australian Financial Review (23 Feb 1984) pointed out that the reduction in deregulatory rhetoric made the report more "saleable" to the Labor Party and some of the local finance institutions:

> The report .. has given the new government an agenda for action which, while not radically different in its practical implications from the Campbell Report, it is much less radical in its expression.

The local banks were the winners. Westpac general manager Bob White enthused of the Martin Report "I couldn't have written it better myself", while other Australian banks also welcomed the report (Carew 1984: 8).

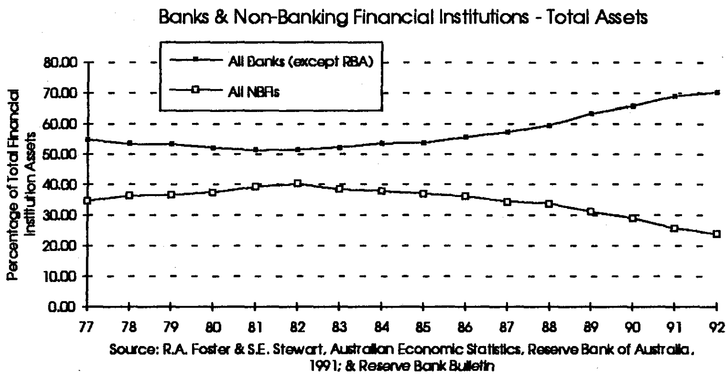
The Broad Outcomes

Greater efficiency through competition was and is the foundation stone of the free marketeers' argument. The removal of borrowing and lending controls and the entry of foreign banks was to lead to a competitively efficient market system, bringing about reduced interest rate differentials between deposits and loans. Competition would eliminate the possibility of monopolistic 'super-profits'. At the same time, both public and private borrowing was to become more efficient in a more certain and better-informed market (Campbell 1981: 758, 771, 800-801; Swan & Harper 1982: 511).

The result has been almost the complete opposite. While there have been more 'players' in the field, the domestic banks have mostly reasserted their dominance through a series of mergers and use of their extensive branch infrastructure. The market share of this handful of large domestic banks, and just a few of the foreign banks, has increased significantly since the early 1980s, whether measured by asset share or share of total loans. Jones (1991: 16-17) points out that the major strengthening of the domestic banks' position, post-deregulation, was through mergers.

Figure 1 shows that in the period after deregulation the domestic banks clearly increased their share of total assets against the Non-Banking Financial Institutions (NBFIs). These changes incorporate the fact that some building societies later converted to banks, contributing to perhaps 4% of the 9% swing back to the banks.

Figure 1: Banks recover their market share from the Non-Banking Financial Institutions



Note: All Banks include: Primary Industries Bank of Australia (from 1988) Commonwealth Development Bank and Australian Resources Development Bank (from 1989); prior to 1990 assets within Australia are shown, but after this the figures include all assets on banks' Australian books. All NBFIs includes: Permanent Building Societies, Credit Cooperatives, Money Market dealers, Pastoral Finance Companies, Finance Companies & General Financiers. Notice that after 1985 some large NBFIs converted to banks, contributing perhaps 4% to the overall 9% swing back to the banks (the largest conversion, that of the St George Building Society, accounted for a shift of around 2.1% of total financial institution assets).

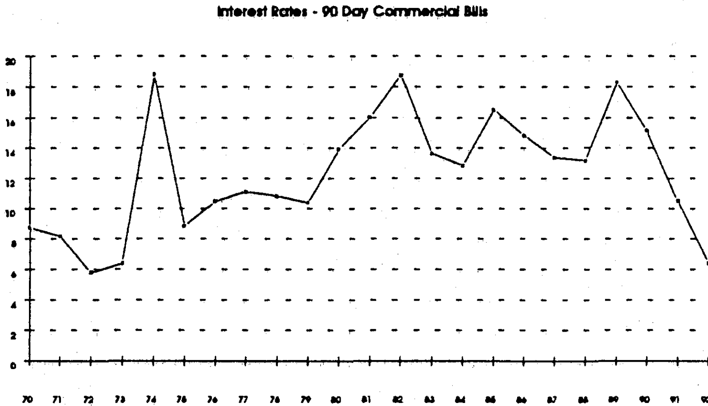
Many of the foreign banks that gained licenses in 1984-1985 suffered losses and generally performed poorly. Foreign banks' returns on equity for 1986 and 1987 were often around 1% or 2%, as against the domestic

banks' average return rate of 10% to 14% (Graham 1988: 13). The position of most of these foreign banks had not improved by 1990, when the Reserve Bank noted their higher level of risky corporate exposure and bad debts, leading to increasing write-offs. This reflected the "wholesale banking nature" of their operations and the Reserve Bank accepted that this higher incidence of bad debt was "in part ... a reflection of increased competition in a deregulated environment" (RBA 1990: 12). Rob Ferguson, Managing Director of Bankers Trust Australia, one of the few profitable foreign-owned banks, predicted in May 1990 that most of the "northern hemisphere banks" would withdraw from Australia within the first five years of the 1990s. Having been unable to compete with the domestic banks in retail or mainstream commercial banking, these banks had targeted higher yielding but higher risk corporate lending areas, being "forced to lower credit standards in seeking these [higher] margins" (Darvall 1990: 41). They were left exposed to substantial bad debt.

More finance was no doubt being made available to the Australian economy, credit to the private sector increasing substantially after deregulation. In the mid to late 1980s the annual increases in credit to the private sector ranged between 18% and 24%, including the stock market crash year of 1987 (RBA 1985-93). Private sector liabilities rose from under 80% of GDP in the early 1980s to nearly 120% by the end of the decade (RBA 1985-93). Much of the new capital came from overseas, and this added to foreign debt problem and growth in the current account deficit (Heywood & Tamaschke 1991: 54-79). The Australian economy was certainly becoming more highly geared.

Interest rates fluctuated wildly in this period (Figure 2). Ninety-day interest rates, responsive to international forces and Australia's chronic current account problems, showed no sign of levelling as the result of deregulation, as had been predicted by Campbell.

Figure 2: Volatility of Interest Rates, Pre and Post Deregulation



Sources for Figures 1 to 5: R.A. Foster and S.E Stewart, *Australian Economic Statistics*, Reserve Bank of Australia, 1991, and; Reserve Bank Bulletin - figures are for 30 June.

Still more dramatic was the widening of interest rate margins. While there had been volatility of interest rates for a brief period in the mid-1970s, the widened differentials between borrowing and lending rates were unprecedented. By any measure of the margins, a substantial gap opened up. Figures 3, 4 & 5 show these margins between borrowing and lending for a range of the most common financial services.

Up until 1984, the margin between average home loans and average investment accounts had stayed around 2%. After deregulation this margin escalated steadily to 3%, then to 4% and 5% (Figure 3). A similar unprecedented widening of margins applied to other combinations of borrowing and lending. The margin between average home loans and interest bearing savings accounts, which had fluctuated between 2% and 10%, rose to a movement between 6% and 14% (Figure 4). The difference between average small to medium overdrafts (of less than $100,000) and term deposits (of various periods) rose from a range of 0-3% to a range of 2-6% (Figure 5).

Figure 3: Interest Rate Margins (A): Average Home Loan Rate minus Average Investment Account Rate

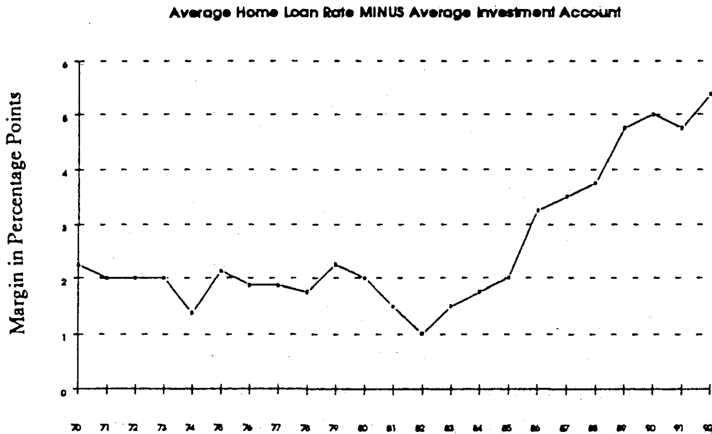


Figure 4: Interest Rate Margins (B): Average Home Loan Rate minus Savings Account Rate

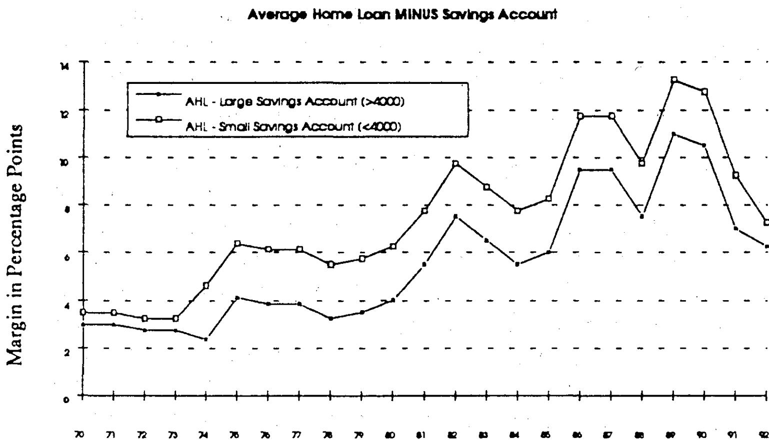
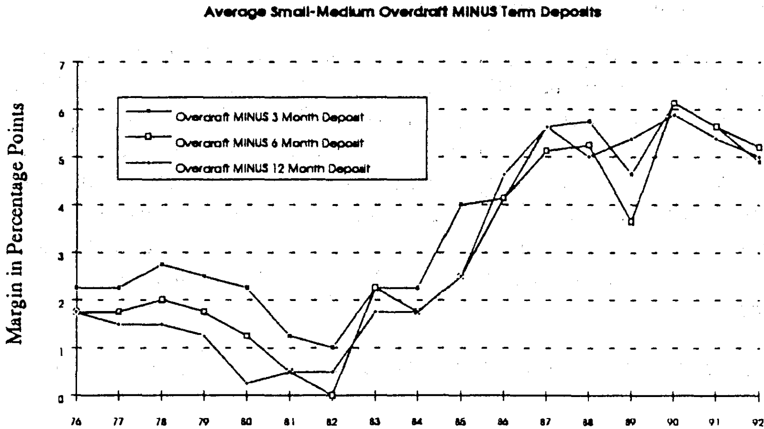


Figure 5: Interest Rate Margins (C): Average Small-Medium Overdraft Rate minus Average Term Deposit Rate



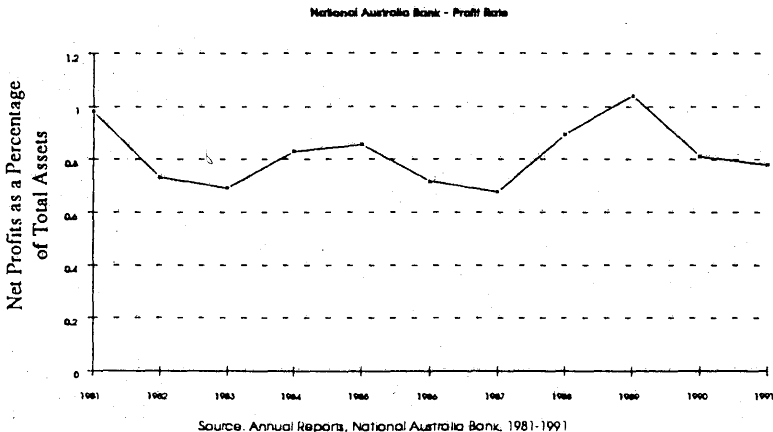
This growth of interest rate differentials was identified by Supriya Singh in 1989. She also pointed to the large body of non-interest bearing deposits with the big domestic banks (Singh 1989). In June 1989 the non-interest bearing deposits of the banks totalled $17.4 billion, or 10.9% of total bank deposits; but by January 1993 these non-interest bearing deposits had declined to $13.9 billion, or 6.4% of total bank deposits (RBA 1993). By this time, though, the margins between the most common forms of borrowing and lending were well above the most common 3% current account rates. The banks were reducing the extent of their non-interest bearing accounts but more than compensating for this loss through their increased interest rate margins.

Did these expanded margins represent direct profits to the banks? In the climate of expanded commercial credit and high interest rates, the banks did have to budget for increasing bad debts. At the same time, their branch structures were expanding and technological innovations such as automatic teller machines (ATMs) were being introduced. By 1991 the National Australia Bank, for example, had simultaneously expanded its provisions for bad debt to $1.3 billion, increased its

branches and business outlets (including its international acquisitions) to 2,473 (from 1,661 in 1981) and its automatic tellers to 772 (from 90 in 1982) and had made another net, post-tax profit of over $700 million (NAB 1981-92). Banks were budgeting for losses but also investing in expansion and making substantial profits.

In a climate of high interest rates in late 1989, Westpac and the National Australia Bank had announced post-tax profits of $790 million and $782 million respectively (Maley 1989b: 25). These levels appeared to be substantially higher than those of the German and US banks (Maley 1989a: 1) and were largely based on the expanded interest margins. Over the decade of the 1980s, despite the losses from big defaults, it is clear that the banks did not lose. Figure 6 illustrates this point by reference to the National Australia Bank's net profit as a percentage of total assets.

Figure 6: The National Australia Bank's Profit to Asset Ratio



Source. Annual Reports, National Australia Bank, 1981-1991

Explaining failure

The broad outcomes are so contradictory to the predictions of the deregulators and to orthodox economic assumptions that one would

have thought some explanation was required. However, official explanations have been fragmented and not coherent. The emphasis has been on the undisciplined lending by the banks and their bad debts. Bankers, journalists and politicians alike have referred to the experience of the 1980s as a learning process, suggesting that the "mistakes" which were made will not be repeated. Comments by banker Rob Ferguson and journalist Michael Stutchbury (Lateline 1990) fall into this category.

Special circumstances have been pleaded. Tom Valentine has argued that, to the extent that events went against the Campbell Committee's predictions (ie. the current account deficit rose, interest rates and asset prices rose, and there was high level of bad debts), it was because the Committee could not have foreseen conditions of the late 1980s. In any event, the Committee had only advocated a "free market situation" which by its nature was unpredictable but, in any case, desirable (in Macfarlane 1991: 36-58).

Perhaps more frank was James Perkins' mixed conclusion that, while he supported the dismantling of the old regulations and presumed competitive benefits would flow from this deregulation, there had been some substantial contrary outcomes:

> The presumption would be that the country benefited from the removal of the large number of arbitrarily chosen controls over bank interest rates and asset structures. But one consequence appeared to be a substantial increase in the relative strength, and probably the profitability, of banks, especially the major banks ... but at least potential borrowers had a wider range of banks, and other intermediaries, from whom to seek accommodation, and many new types of financial products were available (though that was not necessarily a consequence of deregulation) (Perkins 1989: 47).

Others have argued that financial deregulation was a necessity, given Australia's traditional dependence on capital imports and the demands of international capital. Such a pragmatic approach is taken by many politicians and some bankers (eg Ferguson in Macfarlane 1991: 143-166). In fact, deregulation as an 'inevitability' seems to have

overshadowed the arguments over 'welfare gains' through efficient market mechanisms. This former argument, however, leaves the latter unresolved.

I suggest that the broad outcomes of financial deregulation in Australia were neither generally unpredictable nor inconsistent with an increased level of competition. The important issues to be considered - which were not properly considered by the advocates of more open financial markets - were the starting point of the deregulation and the nature of the Australian financial markets.

The freedoms created by financial deregulation were not general freedoms by which financial consumers could interact with an array of equally placed suppliers to enforce a stronger level of consumer sovereignty. The new freedoms were in fact merely a removal of restrictions on the biggest players in an oligopolistic market (restrictions which had been historically compensated for by privileged government guarantees), so that these heavyweights could claw back the market share they had lost to other smaller, but still very large, institutions. The political quid pro quo for these new freedoms to the big domestic banks was allowing the entry of foreign banks and some wider freedoms to financial institutions in general. The latter, however, did not counterbalance the former. The domestic banks, through their superior infrastructure, privileged semi-official status and massive head start, gained a decisive advantage.

Increased competition in these circumstances allowed a dominant group to strengthen its hold on the financial markets. The underlying assumption that an increase in any form of competition would invite the supposed benefits of a perfectly competitive model was unsound both in principle and practice. So much was clear from the theory of imperfect competition, where the irrelevance of consumer sovereignty and marginal cost in monopoly or oligopoly markets had been demonstrated a long time ago (Robinson 1933).

In Australia in recent years there has been growing criticism of 'economic rationalism', a dependence on neoclassical assumptions of efficiency and equity associated with "the market" (eg. Pusey 1991). There appears to be a widespread disregard for the important

distinctions between different types of markets, and different forms of competition. This has been termed a "fundamentalist attitude to the market" (Alford 1992, 766-767).

What the fundamentalist attitude has swept aside is some well-established insights into the limits of competition. Competition in imperfect markets leads to fundamentally different outcomes than does competition in the so-called 'perfect' markets. Galbraith noted three decades ago (1962: Chapter IX) that competition as a dominant mode had been superseded in modern industrial society, and raised serious doubts about the desirability of governments attempting to create oligopoly competition from a monopoly market. Joan Robinson's earlier observations (1933: ix) that monopoly investment may be strong and dynamic, contrary to orthodox assumptions (that monopoly investment is weak and stagnant), also appear relevant to the Australian banks. Super-profits derived from the banks' expanded margins were used to invest, expand and consolidate their grip of the market. Baran and Sweezy's general proposition about the USA (1973: 19-20) holds equally true for an analysis of Australian markets:

> It is ... impermissible to ignore monopoly [including oligopoly] in constructing our model of the economy and to go on treating [perfect] competition as the general case ... we must put [monopoly] at the very centre of the analytical effort.

Policies to increase competition can, and in the case of Australian financial markets did, lead to greater inefficiency and acted to entrench dominant oligopolistic institutions. The lesson here is that the effects of competition in general should not be equated with the supposed allocative, efficiency and distributive benefits of textbook 'perfect competition'.

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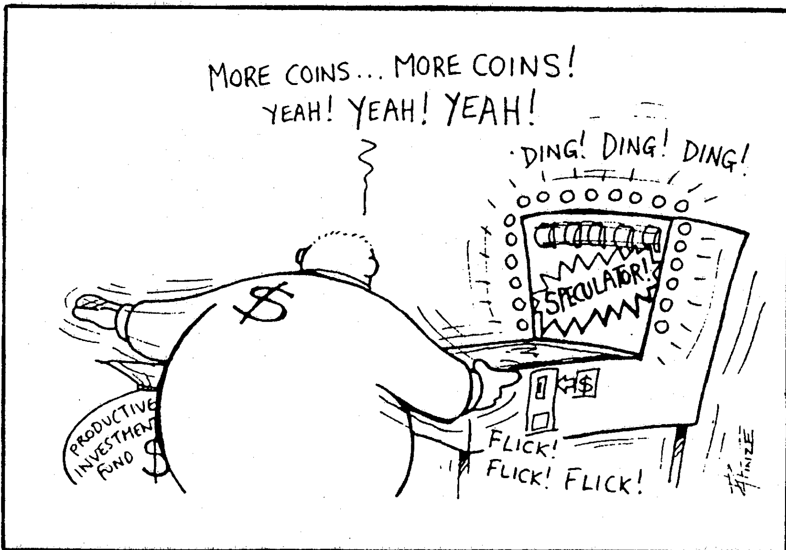

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