

## Overview

- This chapter analyses the implications of financial deregulation for the Australian economy. It considers allocative efficiency, external adjustment, monetary policy, savings behaviour, growth and employment.

## Key Findings

- The removal of exchange controls accelerated the integration of Australian capital markets with international capital markets. This applied a more global framework of opportunities to the investment both of Australian owned capital and of foreign owned capital in Australia. In both respects this is likely to have been beneficial to Australia.
- Many financial institutions and many borrowers took time to adjust to a deregulated financial system. The result was a rapid expansion of credit to the private sector, a sharp rise in asset prices, and a subsequent correction in the early 1990s with associated bad debts and bankruptcies. This transitional process probably involved costs to the real economy during both boom and correction.
- More recently, measures of productivity in the Australian economy suggest an upturn during the 1990s. This may be attributable in part to greater allocative efficiency resulting from financial deregulation. These gains are likely to predominate in the future.

- Exchange rate flexibility has been appropriate because Australia's economy frequently needs to adjust to changes in the terms of trade and other economic fundamentals.
- Scrutiny of governments' economic policies by financial markets may be viewed either as a constraint or as a discipline. However, such market scrutiny has not prevented the implementation of redistributive policies.
- Financial deregulation has allowed monetary policy to be focused on price stabilisation. During the 1990s, the Reserve Bank of Australia has succeeded in maintaining low and stable inflation.
- The weakness in national savings in the period since deregulation does not appear to have been strongly associated with deregulation. It is due mainly to low public sector savings, especially as a result of Commonwealth government budget deficits.
- Private sector net wealth has increased, at an accelerated rate, during the period since deregulation—*notwithstanding* any increases in foreign ownership and foreign indebtedness.
- Long-run growth in the Australian economy is the result of increases in inputs of productive factors (notably capital and labour) and increases in productive efficiency. To the extent that financial deregulation has increased the Australian economy's access to capital or its allocative efficiency, it has increased the economy's growth potential.
- The impact of financial deregulation on long-term employment, if any, is likely to have been through its impact on economic growth rather than through any direct linkage.

# Stocktake: The Economy

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## 17.1 Introduction

This chapter deals with issues in the Inquiry's Terms of Reference concerning the effects on the Australian economy of financial deregulation. These issues reflect the concerns of members of the public, including some presented in submissions to the Inquiry, and debates among economists in Australia and overseas. The Inquiry's approach has been to examine and summarise the available evidence about these issues.<sup>1</sup>

The most relevant aspects of Australia's financial deregulation for the functioning of the economy as a whole were:

- removal of interest rate and lending controls, where they applied;
- removal of restraints on capital inflows and outflows; and
- allowing the value of the Australian dollar to be determined by market forces, subject to occasional intervention by the Reserve Bank of Australia (RBA).

Taken together, these:

- accelerated the integration of Australian financial markets with other financial centres — in effect, substituting a global frame of reference for a domestic one in the allocation of investible

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1 The Inquiry has chosen not to conduct this examination through modelling exercises. The results of any such modelling would necessarily depend on a hypothetical 'no-deregulation' base case with which actual performance could be compared. However, such a base case requires a series of quite arbitrary assumptions about policy choices through the whole period since the early 1980s.

Australian capital, and enlarging the opportunities for foreign capital to be invested in Australia;

- implied a change in the method of adjusting the economy to cope with external imbalance — relying more on exchange rate variations and correspondingly less on changes in monetary conditions and interest rates;
- enabled monetary policy (the authorities' influence on domestic cash rates) to be focused on keeping inflation low and stable, without the added task of offsetting short-term capital inflows and outflows; and
- made borrowing easier for both businesses and private individuals, with some implications for private saving.

Most of this chapter is organised around these four sets of implications — allocative efficiency, adjustment, monetary policy and saving.

Australia's experience during the past 15 years has been disappointing to many people in two important respects — unemployment has remained persistently high, as has the current account deficit. This experience has created a sense of disappointment or scepticism about the dual strategies of opening the Australian economy to international competition and deregulating markets. However, this chapter argues that neither high unemployment nor a high current account deficit can be attributed to financial deregulation.

## **17.2 Allocative Efficiency**

This section addresses the contributions of financial deregulation to the improvement of allocative efficiency, identifying them in a roughly chronological sequence.

The main points are as follows.

- The removal of exchange controls accelerated the integration of Australian capital markets with international capital markets. This brought the investment of Australian owned capital into a more global environment and encouraged the investment of foreign

owned capital in Australia. Both developments are likely to have been beneficial to Australia.

- The removal of interest rate controls contributed to the restoration of interest rates to positive real levels. This provided more appropriate incentives for investing and saving.
- Many financial institutions and many borrowers took time to adjust to a deregulated financial system. The result was a rapid expansion of credit to the private sector, a sharp rise in asset prices, and a subsequent correction in the early 1990s with associated bad debts and bankruptcies. This pattern was common to other countries which deregulated around the same time, although Australia's economy did not undergo as dramatic a boom nor as severe a correction as some others.<sup>2</sup> The process probably involved costs to the real economy during both boom and correction.
- Measures of productivity in the Australian economy suggest an upturn during the 1990s. This may be attributable in part to greater allocative efficiency resulting from financial deregulation.

### 17.2.1 Exchange Controls

Prior to deregulation, capital flows were subject to a wide range of controls. In particular, there were restrictions on holdings by Australian residents of foreign currency balances (apart from minimum working balances held by banks), and on holdings by non-residents of Australian currency balances. Restrictions were also imposed on overseas investment and borrowing by Australian residents, and on non-resident borrowing in Australia.

There is evidence that, by the late 1970s, banks and market participants generally had become adept at circumventing these controls, reducing the inefficiency associated with them.<sup>3</sup>

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2 Comparative figures for asset price movements are presented in Borio, Kennedy & Prowse 1994, Tables 1, 2, 5 and 6.

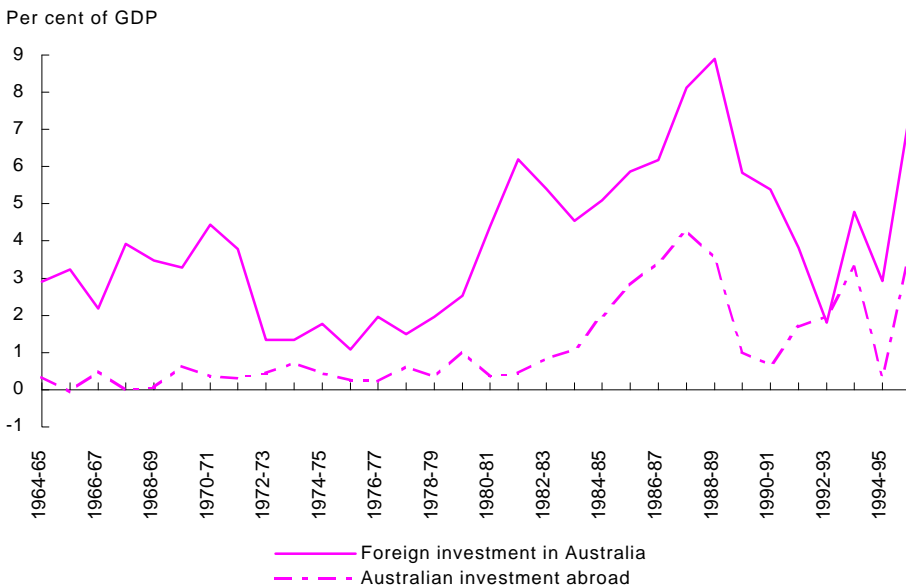
3 Harper 1986; Milbourne 1990, pp. 229-30.

The dismantling of these exchange controls at the end of 1983 (when the exchange rate was floated) accelerated the integration of Australian financial markets with international capital markets.

This involved two concurrent aspects. First, flows of capital across the exchanges were greatly magnified: this is reflected in the large (on average) inflows of foreign investment to Australia since deregulation and the sharp rise in overseas investment by Australians, shown in Figure 17.1.

### **Non-Official Capital Flows Grew after Deregulation . . .**

Figure 17.1: Annual Net Flows of Non-Official Capital



Note: In any comparison with Figure 4.4, it should be noted that this figure shows annual net flows rather than end-of-year levels, and excludes official capital flows, which were sizeable in some years.  
Source: RBA 1996, *Reserve Bank of Australia Bulletin*, various editions; ABS 1996, Cat. no. 5302.0.

Secondly, interest rates in Australia, both short-term and long-term, became more closely correlated with those in the world's main financial centres, especially the United States.<sup>4</sup>

In the domestic economy, adjustment of financial institutions' deposit and loan rates to internationally transmitted changes in money market rates has become more complete and more rapid since financial deregulation.<sup>5</sup>

In principle, this accelerated integration of Australia's financial system with global capital markets should have improved allocative efficiency by:

- offering domestic investors a greater range of investment opportunities, including greater scope for diversification;
- offering overseas investors greater access to Australian productive opportunities; and
- applying through the financial system a structure of interest rates determined in a global economic framework.

## 17.2.2 Interest Rate and Lending Controls

Throughout the post-1945 period until deregulation, Commonwealth governments imposed ceilings on the interest rates payable on bank deposits and loans, controls on the maturities of interest bearing deposits at banks, and restrictions on lending by banks and life companies.

These measures can be presumed to have inhibited the allocative efficiency of the Australian financial system, although their effect could not be and still cannot be measured directly. Because other financial institutions coexisted with banks (and in some cases, thrived) in the regulated era, the probable effect of interest rate controls was to impose some additional cost on

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4 de Brouwer 1997. RBA research has shown that coefficients of correlation between changes in Australian and US long-term bond rates rose markedly from the 1970s to the 1980s and again to the 1990s, see RBA 1994, *Reserve Bank of Australia Bulletin*, April edition, pp. 18-19, and more recent unpublished research provided to the Inquiry. This subject is also discussed in Chapter 9.

5 This has been documented recently in de Brouwer 1995, for Australia and a group of other Western Pacific economies.

obtaining similar services elsewhere, while depressing the returns available from depositing funds with banks.<sup>6</sup>

When interest rate and lending controls were removed in the early 1980s, the necessary conditions were established for resources to flow to their highest-value uses.

Removal of these constraints probably also contributed to the return of interest rates, both short-term and long-term, to levels which were positive in real (inflation-adjusted) terms.<sup>7</sup> During the inflation of the 1970s, market interest rates in Australia had not risen commensurately. This happened only at the beginning of the 1980s, as shown in Figure 17.2.

Allocative efficiency requires that the level of real interest rates be broadly consistent with the marginal productivity of capital, which is fairly steady through time, while nominal interest rates should vary with changes in expected inflation. Unless nominal interest rates are able to reflect expected inflation in this way, increases in inflation result in transfers of real wealth from lenders to borrowers. In principle, removal of interest rate controls could only have improved the allocative efficiency of the financial system.

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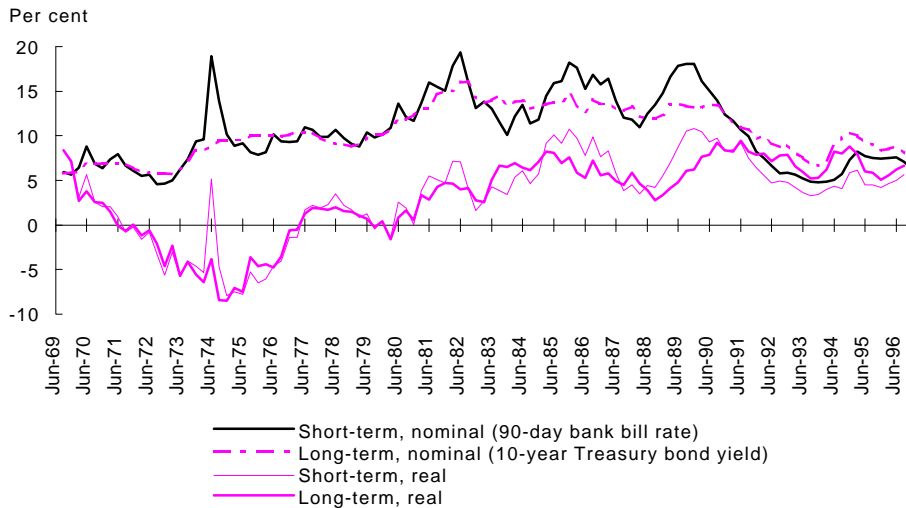
6 Extensive analysis has been made of the welfare effects of regulation and deregulation of banks' lending rates for owner-occupied housing, taking account of inflation and tax treatment. See, for example, Albon & Piggott 1984 and Albon, Findlay & Piggott 1984.

7 Other factors may also have contributed — for example, declines in government and private saving, see Tease, Dean, Elmeskov & Hoeller 1991, sections II & III, and Andersen & White 1996, p. 66.



## **Real Interest Rates Returned to Positive Levels after Deregulation . . .**

Figure 17.2: Nominal and Real Interest Rates



Note: Interest rate observations are quarterly averages. The conversions to real rates use increments in the GDP deflator over the four quarters to the interest rate observations — that is, they assume extrapolative expectations of inflation.

Source: RBA 1996, *Reserve Bank of Australia Bulletin*, various editions.

### **17.2.3 Transitional Costs**

In Australia as in other countries where financial systems were deregulated around the same time, several transitional factors detracted initially from the contribution which financial deregulation could make to allocative efficiency.

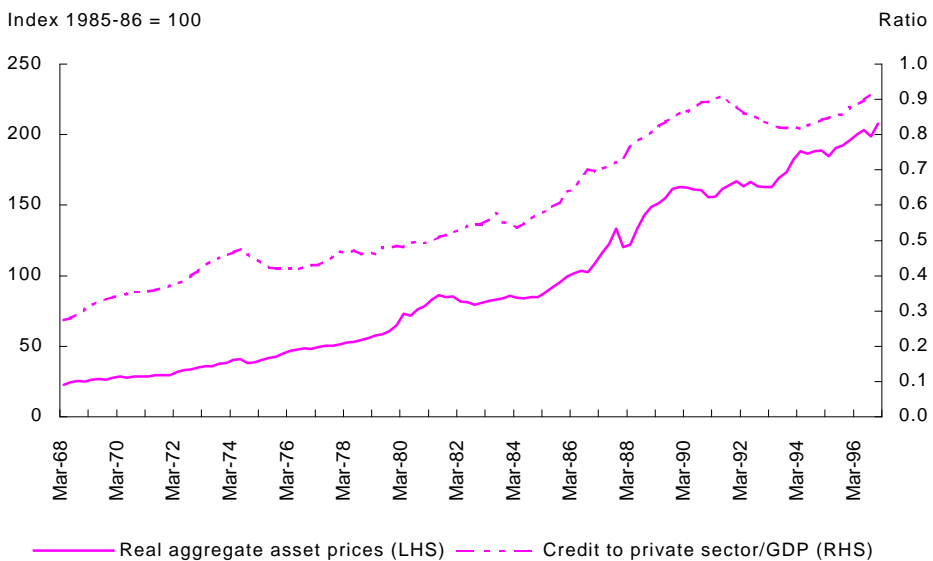
In the early years following deregulation, investment was probably attracted into inefficient areas as a result of pre-existing distortions of investment incentives — trade barriers, other industry assistance, tax preferences, and rigidity in wage rates. Many of these distortions were subsequently reduced.

Secondly, allocative efficiency was probably impaired by excessive expansion of credit to the private sector, a resulting boom in asset prices in the late 1980s, and a sudden correction in the early 1990s. Figure 17.3 shows that real asset prices and private credit as a proportion of gross domestic

product (GDP) grew together, unusually rapidly, from the mid-1980s until the early 1990s.

### **Asset Prices and Private Credit Rose Together Rapidly after Deregulation . . .**

Figure 17.3: Real Aggregate Asset Prices and Credit to the Private Sector as a Proportion of GDP



Source: RBA estimates. Quarterly figures for total private credit prior to 1977 are interpolated from annual data.

Financial deregulation contributed to this process by creating an atmosphere of intense rivalry for market share, and by enabling banks to expand in areas of business in which they had previously been constrained. The established banks' competitive response to the prospect of competition from new foreign banks was in most cases to expand their business lending vigorously. In the process, they accepted lower-quality business which later gave rise to unusually high levels of bad debts.

According to staff of the Bank for International Settlements (BIS), the relaxation of credit constraints in the finance industry in a group of countries

including Australia, when combined with pre-existing tax provisions which encouraged indebtedness, ‘provided fertile ground for a self-reinforcing spiral of credit and asset prices, with faster credit expansion raising asset prices and higher asset prices in turn relaxing credit constraints further.’<sup>8</sup>

While the losses of financial institutions flowing from the correction of asset prices in the early 1990s were large, they should not be taken as measures of the costs of those losses to the economy as a whole. Some losses of financial institutions caused by transactions at artificial prices simply represented wealth transfers, with no necessary net effect on real investment and output.

The third notable impairment of allocative efficiency in the transition to financial deregulation occurred in the early 1990s when over-exposed financial institutions tried to minimise their risk in new lending and to restore their capital through wider margins on existing and new loans. This approach was followed wherever competitive pressures permitted — notably for small and medium enterprise (SME) and household borrowers. It reduced the availability of new loans and raised the interest cost of borrowing. This may have depressed aggregate investment, or caused sub-optimal allocation of investments in the SME and household sectors.

Finally, it is sometimes argued that allocative efficiency in this period was further impaired by a reduction of time horizons, or ‘short-termism’, on the part of institutional investors and financial markets. Some have argued that financial deregulation caused this change of attitudes, and that it diverted both private and public investment from some projects which would have been viable in the long term.<sup>9</sup>

General attitudes may indeed have been influenced by financial deregulation, but it is impossible to isolate one set of influences from others which operated at the same time. It should be remembered that financial

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8 Borio, Kennedy & Prowse 1994, p. 29. The statistical tests done by these BIS staff members corroborate the role played by credit in Australia’s asset price boom of 1982-89, after taking account of other explanatory factors — see Graph 6 p. 36 and Table 11 p. 40. This occurred even though Australia’s inflation-adjusted interest rates were relatively high — see their Graph 2 p. 25, and Figure 17.2 in this chapter.

9 See the survey in EPAC 1995, *Short-termism in Australian Investment*, based on a workshop held in November 1994.

deregulation was a policy response to external trends, and so should not be regarded as the cause of those trends.

In summary, Australia experienced a lengthy — and possibly costly — transition to the different disciplines and dynamics of a deregulated system. During the 1990s, however, the more visible signs of transition including high levels of bad debt, asset price instability and poor risk management diminished. The length of the transition period appears to have been common to other countries which deregulated their financial systems in the 1980s.<sup>10</sup>

## 17.2.4 Overall Productivity Improvements

From the mid-1990s onwards, the contribution of financial deregulation to allocative efficiency appears to have emerged more clearly.

Analysis conducted in 1995 by the Economic Planning Advisory Commission (EPAC)<sup>11</sup> suggested that capital productivity in the Australian economy (the ratio of GDP to the capital stock, or output per unit of capital) stabilised after deregulation following a marked down-trend during the preceding decades.<sup>12</sup>

That stabilisation of overall capital productivity following deregulation was due mainly to a marked improvement in capital productivity in the public sector. The improvement in public sector performance resulted from factors specific to that sector, and is not directly attributable to the financial system.

EPAC found that in the private sector in the decade following deregulation, capital productivity declined very slightly. At the time of the EPAC analysis there had been an improvement in overall capital productivity in the year 1993-94, but this was insufficient as evidence of an upturn.

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10 Edey & Hviding 1995, p. 15; Andersen & White 1996, pp. 67-68; Johnston & Pazarbasioglu 1995, especially pp. 10-13.

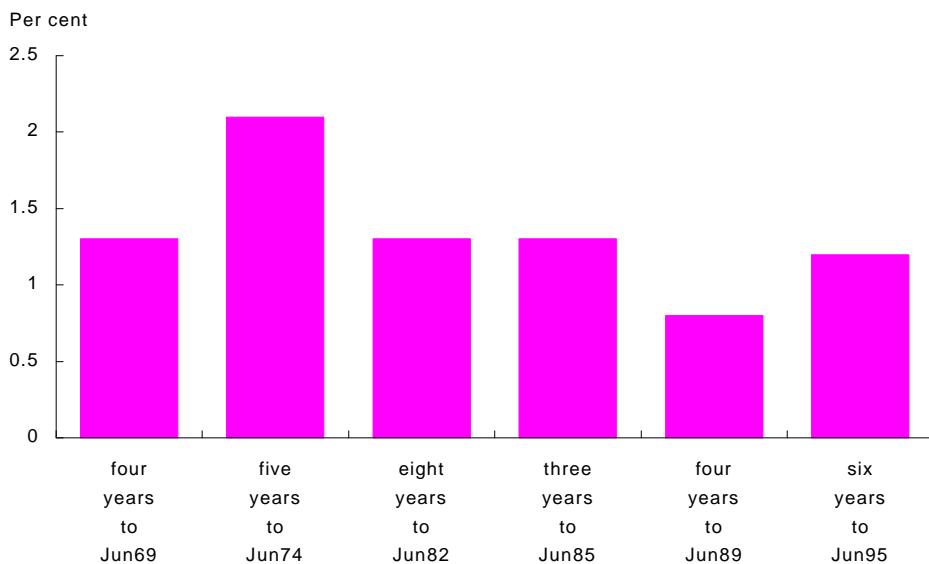
11 EPAC 1995, *Investment and Economic Growth*, pp. 13-15.

12 In addition to EPAC's analysis of productivity trends, see FitzGerald 1993, p. 10, which summarises some OECD analysis.

Since then, however, there has been clearer evidence of an improvement in total factor productivity during the growth cycle of the 1990s in the non-farm market sector of the economy (see Figure 17.4). When total factor productivity increases, GDP grows faster than is attributable to additional inputs of labour or capital. This excess is attributable to improvements in technology (historically, the main contributor), greater efficiency of labour, capital and management, or some combination of technology and efficiency improvements. Although direct comparisons of productivity growth in different countries are difficult, data supplied to the Commonwealth Treasury by the Organisation for Economic Cooperation and Development (OECD) suggests that the growth rate of total factor productivity in Australia's business sector has exceeded the average for OECD member countries in the early and mid 1990s.

### ***Productivity has Improved in the 1990s Upturn . . .***

Figure 17.4: Total Factor Productivity —  
Compound Annual Percentage Change between Growth Cycle Peaks



Source: ABS 1995, Cat.no.5234.0.

In summary, while the costs of transition to a deregulated financial system appear to have predominated initially, it appears that during the 1990s when the main lessons had been learnt, the gains from greater allocative efficiency emerged more clearly. This general picture corresponds to the experience of other OECD countries which deregulated their financial systems around the same time as Australia.<sup>13</sup>

## **17.3 Method of External Adjustment**

Two key elements of financial deregulation were the floating of the Australian dollar in December 1983 — allowing the market to determine its exchange rates, subject to occasional intervention by the RBA — and the concurrent removal of restraints on capital movements into or out of Australia. Both had important implications for the way in which the Australian economy adjusts to changes in the external economic situation.

The main points are as follows.

- Allowing exchange rate flexibility, in the face of the forces embodied in foreign-exchange markets, is appropriate to the circumstances of Australia's economy — in particular, the frequent need for adjustments to changes in our terms of trade and other economic fundamentals.
- Alternative policies, involving greater efforts to defend or maintain particular levels of the exchange rate, are likely to have involved costs associated with speculative attacks, and perhaps also the economic costs of having an exchange rate out of line with economic fundamentals.
- Having a floating exchange rate may have added to the pressures to move from centralised wage setting to more flexible arrangements.
- There has been debate about whether exchange rate volatility imposes unnecessary costs on the economy. The available evidence does not point to substantial increases in either volatility or associated economic costs.

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13 Edey & Hviding 1995, p. 15; Andersen & White 1996, pp. 67-68 & 75.

- Analysis of exchange rate movements since deregulation suggests that:
  - changes in economic fundamentals have played an important part;
  - the market's assessments of economic policies — especially their appropriateness and sustainability — have also played a part; and
  - there may nevertheless have been some inefficiency in the way the market sets exchange rates.
  
- The financial markets' scrutiny of economic policies and possible adverse reaction to them may be viewed negatively, as a constraint, or positively, as a discipline. It would, however, be a misreading of the facts to regard market scrutiny as having thwarted redistributive policies.

### **17.3.1 Need for Frequent External Adjustments**

Australia has a small economy which became considerably more open to international trade during the 1980s and 1990s. Our economy is distinguished from those of most other OECD countries by its susceptibility to variations in the terms of trade (the ratio of weighted average export prices to weighted average import prices). Persistent movements in the terms of trade affect internal economic conditions, especially if they affect assessments of the export potential of Australian natural resources and investment activity.

The openness of the Australian economy forces us to adjust frequently and often substantially to changes in our external circumstances. It is therefore highly desirable that our nominal exchange rate be flexible, because a flexible

exchange rate is the most rapid and efficient means of driving internal adjustment processes.<sup>14</sup>

A flexible exchange rate means that adjustment to changing external circumstances can take place without general price inflation or disinflation. Changes in the relative prices of traded and non-traded goods (the real exchange rate) occur through changes in the domestic price of foreign currency (the nominal exchange rate). These relative price changes facilitate the necessary switching of resource flows to accommodate the change in external circumstances. They are generally much quicker and less disruptive of domestic economic conditions than general price inflation or disinflation.<sup>15</sup>

On occasions, the need for adjustment within the economy is brought about not by external but by internal events, such as major changes in domestic costs or disruptions of production. In these cases as well, a floating exchange rate generally facilitates adjustment at least cost, because it involves supportive changes in relative prices in the domestic economy.

In view of the evidence now available and given the continuing need for the Australian economy to adjust flexibly to changes in our external economic circumstances, the decision to float the Australian dollar was appropriate.

Throughout the period since deregulation, some governments around the world have continued with 'managed floating' of their exchange rates. European governments have had adjustable target zones for their exchange rates as part of regional economic integration. Other governments, including a number in the Asia Pacific region, have attempted to minimise the potential costs of exchange rate variability by 'anchoring' the exchange rate

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14 Blundell-Wignall & Gregory 1990; Blundell-Wignall, Fahrer & Heath 1993; Bullock, Grenville & Heenan 1993; Pitchford 1994; Gruen & Shuetrim 1994. This broadly corresponds to the main economic advice given to the Campbell Committee on exchange rate policy.

15 There can be changes in prices of exports or imports which do not represent changes in the terms of trade. In these cases, a flexible exchange rate can be expected simply to insulate domestic prices from the foreign price movements.



of their currency to that of a large, low-inflation country.<sup>16</sup> The anchoring approach seems inadvisable in Australia's circumstances.

- It might expose the RBA to speculative attack in the foreign exchange markets.<sup>17</sup>
- There is no obviously suitable anchor country, which needs to be one with a fairly similar economic structure and corresponding changes in its external economic situation.

### 17.3.2 Implications for Wages

The relationship between exchange rate movements and wage adjustments is fundamental to the way an economy adjusts to changing external circumstances. Some flexibility in real wage levels is essential for adjustment to take place through a floating exchange rate. If wage indexation were to compensate fully for price changes resulting from exchange rate movements, those exchange rate movements would be ineffective as a means of domestic adjustment. Recognition of this principle in the partial non-indexation of wages in the second half of the 1980s permitted the depreciation of the Australian dollar during those years to have its full adjustment effect.<sup>18</sup>

It also became generally recognised that under a floating exchange rate regime, general wage increases which were not supported by increases in productivity would probably lead merely to exchange rate depreciation, eroding the wage increases in real terms.

In these respects, financial deregulation added to pressures on Australia's centralised wage fixing arrangements, and probably contributed to decisions in the late 1980s and 1990s to introduce greater flexibility into wage fixing.

More generally, the floating of the Australian dollar and the ensuing depreciation in the mid-1980s sent a clear message to Australian businesses,

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16 For a comparative analysis of the 'anchoring' issue in Australia and this region, see Garnaut 1994.

17 Macfarlane 1994, p. 12.

18 Blundell-Wignall & Gregory 1990, pp. 264-66.

workers and the public that cost increases could not be passed on to international buyers, but would only induce exchange rate depreciation. In this way, financial deregulation has been instrumental in convincing Australians of the international economic environment in which wage and price decisions are made.

### 17.3.3 Determination of the Exchange Rate

The variability of the exchange rate since deregulation gives rise to two related questions:

- whether its volatility — short-term variations, lasting for some days or weeks, around a mean or trend — inhibits economic activity; and
- whether, aside from short-term volatility, the market determined exchange rate deviates persistently from some equilibrium level and thereby imposes real costs on the economy.

Figure 17.5 shows that the volatility of the Australian dollar vis-a-vis the US dollar increased during the 1980s. Volatility also increased in the trade-weighted index of the Australian dollar. However, in the 1990s the exchange rate has not been much more volatile, on average, than during the period of a managed exchange rate, from 1976 to 1983.<sup>19</sup>

In any case, volatility does not necessarily impose costs on the operation of businesses or other economic activity, given the existence of forward cover and other arrangements for managing short-term risks of exchange rate movements.

Numerous studies have found that the market determined exchange rates of the currencies of major OECD countries have demonstrated substantial and persistent discrepancies from real equilibrium levels implied by economic fundamentals.<sup>20</sup> These discrepancies may be the result of trading behaviour (such as ‘feedback’ and ‘noise’ trading) in the foreign exchange markets,

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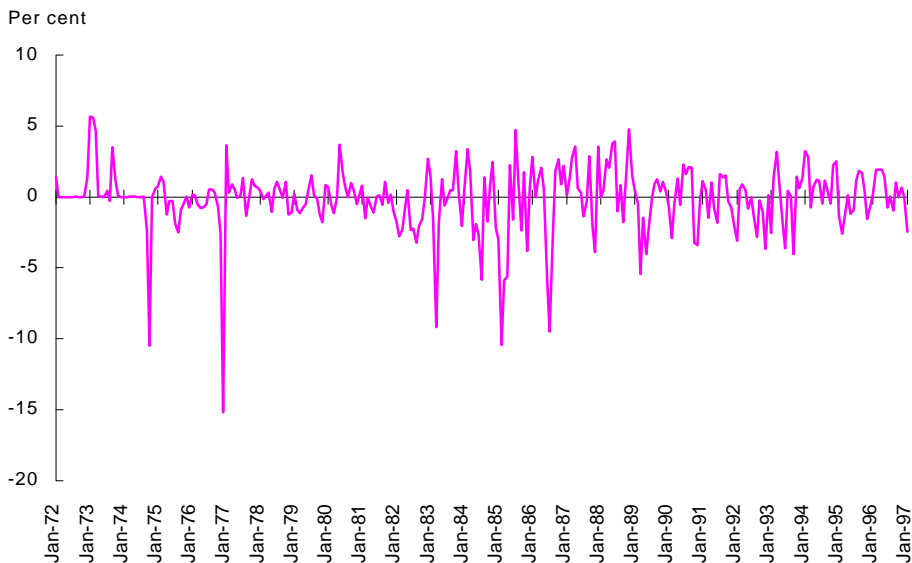
19 This observation was made by Blundell-Wignall, Fahrer & Heath 1993, pp. 38-40, referring to the early 1990s; but it applies also to the longer period from 1990 to 1996.

20 Krugman 1993, pp. 8-12; Blundell-Wignall, Fahrer & Heath 1993, p. 47 n. 10. Both summarise and cite extensive studies by others on this subject.

and perhaps also of the time required to distinguish the temporary and lasting components of economic news such as terms of trade changes.<sup>21</sup>

### ***Exchange Rate Volatility has Diminished in the 1990s . . .***

Figure 17.5: Volatility of \$A/\$US Exchange Rate  
(percentage movements in monthly average)



Source: OECD 1997; RBA 1996, *Reserve Bank of Australia Bulletin*, various editions.

Recent RBA research into the exchange rate of the Australian dollar is consistent with this international picture. This research suggests that the exchange rate, in real terms, tends toward an equilibrium rate which is set by economic fundamentals — notably Australia's terms of trade, net foreign liabilities and long-term interest rate differentials.<sup>22</sup> The research suggests that the nominal exchange rate of the Australian dollar has at times departed considerably from the level implied by the long-term relationship with

21 Blundell-Wignall & Browne 1991, pp. 14-16.

22 Gruen & Wilkinson 1991; Blundell-Wignall, Fahrer & Heath 1993, pp. 45-67.

economic fundamentals, and that this additional variability is most likely caused by the dynamics of financial markets' response to economic news.<sup>23</sup>

The RBA research also suggests that changes in the real exchange rate can be most fully explained by including certain forward-looking factors which reflect the settings (and the market's assessments) of monetary and fiscal policy — the slope of the domestic yield curve relative to foreign yield curves, and changes in the size of the Commonwealth Government budget deficit in proportion to GDP.<sup>24</sup> A combined set of these economic fundamentals and policy factors accounts for most of the variation in the real exchange rate since deregulation. This is shown in Figure 17.6 by the close correspondence between the observed real exchange rate and the rate predicted by a model incorporating these factors.

There is room for argument about whether the differences between actual exchange rates and equilibrium rates implied by economic fundamentals distort trade patterns and investment decisions, and thereby impose real costs on the economy. At present, there is little basis for estimating what such costs might be.<sup>25</sup>

To the extent that the RBA is able to take a better informed view of long-term economic fundamentals, it can play a legitimate role in dampening the impacts of 'feedback' and 'noise' trading in the foreign exchange markets by occasional intervention. It appears to have been reasonably successful in this role in the period since deregulation.<sup>26</sup>

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23 Blundell-Wignall, Fahrer & Heath 1993, pp. 46-50 & 59-66; Gruen & Gizycki 1993; Gruen & Kortian 1996.

24 Tarditi 1996.

25 Blundell-Wignall & Gregory 1990, p. 256 n. 15, which cites studies up to that time.

26 Pitchford 1993, pp. 189-93; Macfarlane 1994, pp. 9-13.

## ***Much of the Variation in Australia's Exchange Rate can be Accounted for . . .***

Figure 17.6: Comparison of the Real Trade-Weighted Index of the Australian Dollar with Values Predicted from Economic Fundamentals and Policy Factors



Source: RBA calculations, from estimates reported in Tarditi 1996.

### **17.3.4 Market Perceptions of Economic Policies**

A major change following financial deregulation is that both the exchange rate and cross-border capital flows are affected by market views about the sustainability of economic policies. In effect, financial markets make continuous assessments of the adequacy of macroeconomic policies in Australia. Through the exchange rate, the markets' assessment affects the cost of borrowing offshore. An unfavourable assessment by the market imposes a penalty on businesses as well as on governments.

This situation can be interpreted in different ways. In some public discussion, and in some submissions to this Inquiry, it has been argued that financial deregulation has undermined our economic sovereignty and put

Australia under the domination of foreign capital. In other public discussion, and other submissions to this Inquiry, the same situation has been viewed positively, as a salutary discipline on economic policy making both in its process and in its content.

The Inquiry's view is that Australia has little choice about whether our economy is integrated with the global economy — that has happened. The choice is how to deal with the opportunities and problems arising from this situation.

The scrutiny of financial markets does place a premium on certain attributes in economic policy making — notably transparency and consistency. It also deters governments from fiscal deficits which might be viewed by the markets as unsustainable.<sup>27</sup> This pressure has contributed to bringing about the marked improvement in the financial performance of public enterprises in Australia since deregulation.

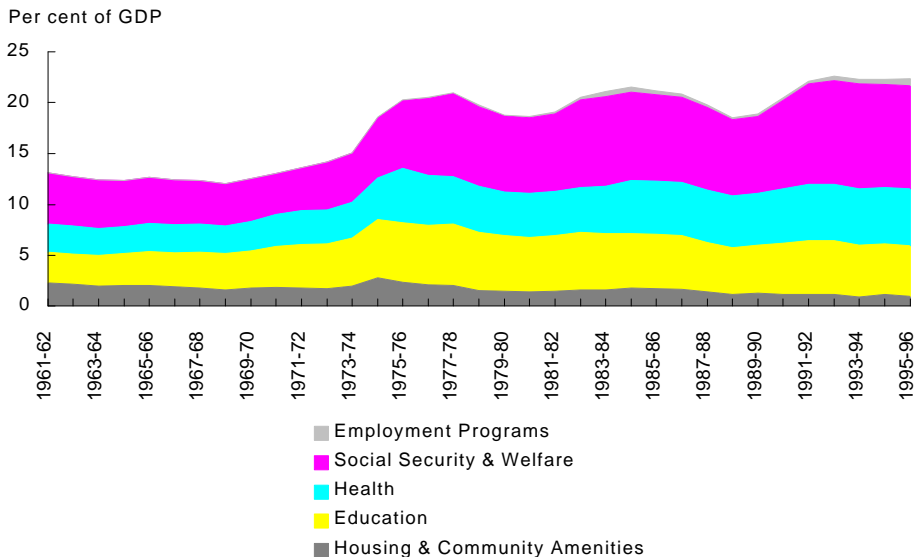
It needs to be emphasised that the pressure on governments from financial markets applies principally to the budget balance rather than to the size of the public sector. Governments in Australia still have a fair amount of latitude in the composition of their budgets. Welfare transfers in Australia since deregulation have continued and even grown, as shown in Figure 17.7. This suggests that financial deregulation has not stood in the way of redistributive policies.

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27 In a recent examination of the effects of financial deregulation in Australia, Argy draws a stronger conclusion: ' . . .there is little doubt that in a small country like Australia, and in the present world environment, deregulated financial markets tend to weaken or even nullify any positive effects from fiscal expansion' — Argy 1995, p. 23 n. 4. See also Argy 1996, pp. 10-14.

## ***Redistributive Programs have Continued after Financial Deregulation . . .***

Figure 17.7: Commonwealth Government Outlays on Social Programs



Source: ABS 1996, Cat. no. 5501.0.

## **17.4 Financial Deregulation and Monetary Policy**

This section addresses the implications for the real economy of changes in the objectives and methods of monetary policy that followed financial deregulation.

The main points are as follows.

- Financial deregulation has allowed a more distinct assignment of monetary policy to price stabilisation. But financial deregulation also introduced greater uncertainty into the assessment of monetary conditions, and the linkages by which monetary policy operates.
- For these and other reasons, monetary policy made little headway in reducing inflation during the 1980s. However, since the start of the 1990s, the RBA has had greater success in maintaining low and

stable inflation. This has reduced the real costs associated with inflation.

- In a deregulated financial system, long-term interest rates are determined mainly by financial markets, with national authorities having some influence through interventions affecting short-term rates and through economic policy settings.
- This provides a framework for allocating savings to investment which is more conducive to economic growth than the alternative policy of attempting to finance investment solely from domestic resources.
- Although integration with international financial markets increases the impact of shocks originating elsewhere on our financial markets, this should be accepted as inseparable from the benefits of integration in the global economy.

### 17.4.1 Change in Monetary Relationships

Allowing the Australian dollar to float at a market determined level involved a fundamental choice to substitute some variability in the exchange rate for variability in short-term interest rates. One or the other, but not both, could be targeted once large amounts of Australian and foreign capital had become mobile. Allowing the exchange rate to float provided greater national autonomy in monetary policy, and scope to assign monetary policy more fully to price stabilisation.

However, financial deregulation also changed the relationships on which monetary policy had previously been based.<sup>28</sup> Financial institutions obtained greater flexibility in funding themselves and in transacting in financial instruments. This altered the relationships among base money, narrow money and broad money, and between these monetary aggregates and real economic activity.

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<sup>28</sup> For general accounts of these changes in the whole set of OECD economies, see Blundell-Wignall & Browne 1991; Edey & Hviding 1995, pp. 20-21; Andersen & White 1996, pp. 72-75. For general accounts of these changes in Australia, see RBA Annual Reports since deregulation; Grenville 1990, *Australian Economic Review*; Milbourne 1990; Fahrer & Rohling 1992; Pitchford 1993.



Accordingly, the focus of monetary policy shifted from financial aggregates to interest rates. In a deregulated system, changes in cash rates induced by the RBA flow through quickly and almost proportionally to most other short-term interest rates. But the effects on economic activity of changes in short-term interest rates have become more complex and changeable.

- Some sectors and groups in the economy are more sensitive to alterations in short-term interest rates than others. The widespread use of variable interest rates for lending, for example, has made households and housing investment sensitive to interest rate variations, whereas the financial sophistication of many businesses and their ability to hedge interest rate movements with derivative products have made them less sensitive by comparison.<sup>29</sup>
- Monetary policy also seems to have a reliable effect on demand through altering the prices of financial assets, and thereby the perceived wealth of businesses and households.<sup>30</sup>
- Monetary policy generates a further set of effects on both demand and prices through influencing the floating exchange rate. Since the late 1980s, more attention has been given to examining these effects, which operate with different lags in different areas of the economy.<sup>31</sup>
- Finally, since deregulation, the reactions of financial markets have become strongly conditioned by interpretations of the authorities' actions, especially their implications for future inflation and interest rates. Market reactions are open to influence by policy statements, but are inherently difficult to predict.<sup>32</sup>

In this evolving situation, it has been difficult to diagnose monetary conditions, and difficult for the RBA to know, if it intervenes to influence

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29 An important aspect of this is whether sectors which obtain credit through banks and other financial intermediaries — notably, small businesses — are consequently more affected by credit tightening than others which obtain funds directly from financial markets. Andersen & White 1996, p. 84, refers to this as part of the 'credit channel' issue.

30 Lowe & Rohling 1993; Andersen & White 1996, p. 62.

31 Andersen & White 1996, p. 74.

32 Blundell-Wignall & Gregory 1990, pp. 225-56; Grenville 1990, *Australian Economic Review*, p. 14; Macfarlane 1994, p. 8; Andersen & White 1996, p. 75.

cash rates, by how much and over what period its intervention will affect nominal demand, inflation and economic activity.

## 17.4.2 Monetary Policy

Throughout the period since financial deregulation, the RBA has directed monetary policy primarily at influencing nominal demand in the economy, according to its charter of pursuing full employment and price stability. However, at several points during the 1980s, monetary policy was influenced, or constrained, by the level of the exchange rate.<sup>33</sup> Because of these constraints and the difficulties faced by the RBA in interpreting the post-deregulation environment, monetary policy made little headway in reducing inflation before the end of the 1980s.<sup>34</sup>

Since the start of the 1990s, the RBA has had greater success in maintaining a low and stable level of inflation. This has reduced the distortions to the economy associated with inflation.<sup>35</sup>

## 17.4.3 Capital Flows

Although a floating exchange rate permits the Australian authorities to pursue a more autonomous monetary policy, international capital flows still impose some constraints.

First, long-term interest rates are largely determined by markets, rather than by monetary authorities.<sup>36</sup> As was noted above, financial deregulation accelerated the process of capital market integration, which increased the correlations among long-term interest rates in different countries. But long-term interest rates have not simply converged to a common level in

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33 Macfarlane 1994, pp. 7-8 & 13-15.

34 See, for example, Carmichael 1990, especially pp. 298-303.

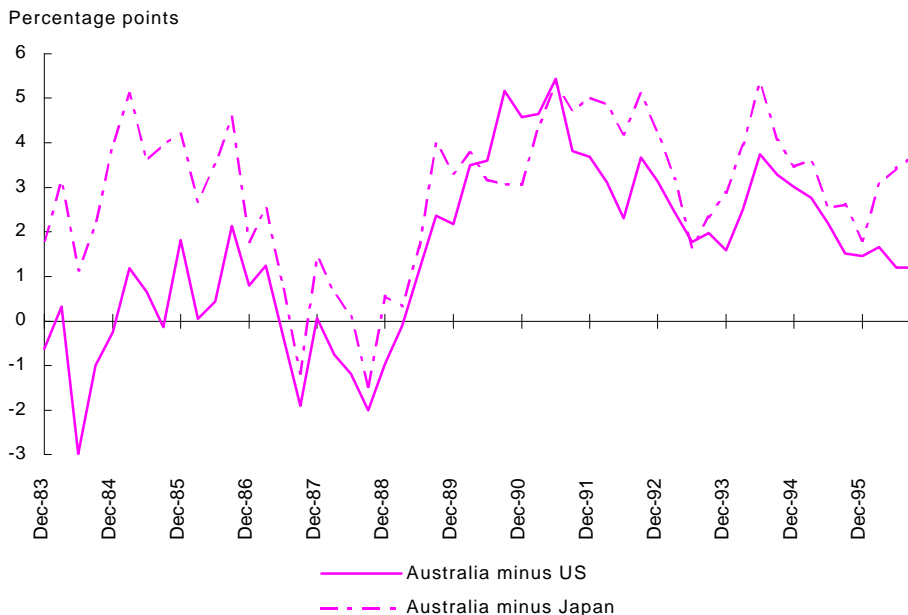
35 On these costs, see the comments by McTaggart and Nevile and the summary of discussion following Carmichael's paper at the Reserve Bank's June 1990 conference, in Grenville 1990, *The Australian Macroeconomy in the 1980s*, pp. 343-353. The inflation objective for monetary policy and its rationale are described in some detail in Debelle & Stevens 1995.

36 Macfarlane 1988, especially pp. 18-19; Blundell-Wignall, Fahrer & Heath 1993, p. 55 n. 16.

real terms.<sup>37</sup> There have been persistent differentials in real long-term interest rates — as shown in Australia's case in Figure 17.8. These differentials are usually explained by reference to 'stickiness' of prices in goods markets, and to possible expectations of change in monetary conditions or country risk premiums.<sup>38</sup>

### ***Real Interest Differentials have Persisted . . .***

Figure 17.8: Differentials between Australian Real Long-Term Interest Rates and those in US and Japan



Source: OECD 1997.

In broad terms, it appears that real long-term interest rates in Australia are determined generally by long-term interest rates in other markets, differences in expected rates of inflation, and domestic short-term interest

37 Blundell-Wignall & Browne 1992, especially pp. 17-20; Andersen & White 1996, p. 61.

38 Gruen & Wilkinson 1991, p. 32; Orr, Edey & Kennedy 1995, pp. 14-15.

rates.<sup>39</sup> Only the latter two are influenced directly by Australian monetary policy.

Secondly, while short-term interest rates are influenced by monetary policy, here again there are some constraints. The term structure of interest rates — the relationship of short-term to long-term rates — must be perceived by the markets as credible and sustainable if monetary policy is to be effective as an influence on nominal demand. These market perceptions are conditioned by assessments of economic policies — in particular, whether they are seen as adequate in addressing economic fundamentals and politically sustainable. This linkage between interest rates and market perceptions of economic policies was discussed in Section 17.3.4.

#### **17.4.4 Levels of Interest Rates**

It has been argued publicly from time to time, and represented to the Inquiry in a number of submissions, that financial deregulation has resulted in generally higher interest rates than would otherwise have been needed, and that these high interest rates have restrained the growth of GDP.

This argument implies that Australia should have followed a policy of greater self-reliance — limiting capital flows to and from the rest of the world in order to insulate domestic interest rates from international markets, and conducting monetary policy (or operating direct controls) to keep Australian interest rates as low as possible.

The greatest cost of such a policy would have been the denial of much of the foreign capital which has been used to develop our resources and industries. Separation from global capital markets would also have reduced the returns on Australian savings and the capacity of Australians to reduce investment risks through diversification.

In the Inquiry's view, it is most unlikely that a policy of greater reliance on domestic capital would have resulted in faster growth or higher incomes — quite the reverse.

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<sup>39</sup> Orr, Edey & Kennedy 1995, especially Table 2a p. 23. See also Gruen 1995, p. 25, and Tarditi 1996.

### 17.4.5 Volatility of Financial Prices

Changes in the prices of assets — equities, long-term bonds and property — which originate in other countries' markets are transmitted quickly through markets to asset prices in Australia.<sup>40</sup> This global linking has several aspects. One negative aspect is that shocks or mood changes which seem to have no basis in Australia can nevertheless affect our financial markets, and may have real economic effects through the price of credit, collateral for borrowing, or the capital adequacy of financial institutions.<sup>41</sup>

This phenomenon needs to be kept in perspective. The closer integration of our asset markets with foreign markets has not led to any notable increase in volatility, as measured by month-to-month changes in short-term interest rates, long-term bond yields, industrial share indexes or overall share indexes, when the whole period from 1984 to 1995 is compared with the period from 1972 to 1983.<sup>42</sup>

Moreover, openness to foreign financial shocks is inseparable from the benefits of integration of global financial markets. Those benefits include the opportunity to have foreign savings supplement our own savings for investment in Australia; the opportunity for Australian owned capital to be invested throughout the world; and a more global, and hence more efficient, allocation of economic resources. In the Inquiry's view, these are the most important elements, and they are positive in their implications for our economy.

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40 Gruen & Shuetrim 1994, section 4, pp. 328-44.

41 For a forceful argument along these lines, see Argy 1995, especially pp. 26-32.

42 Department of the Treasury, Submission No. 143, Appendix E. For international surveys of the same issue, see Gruen 1995; Edey & Hviding 1995, pp. 18-19; Andersen & White 1996, pp. 69-70.

## 17.5 Financial Deregulation and Saving

This section addresses the association between financial deregulation and savings behaviour.

The main points are as follows.

- The weakness in national saving which has been evident in the period since deregulation is due mainly to low public sector saving, especially the underlying budget balance of Commonwealth governments.
- Movements in private saving — where the effects of financial deregulation should have been greatest — do not appear to have been strongly associated with deregulation.
- Private sector net wealth has increased on average throughout the period since deregulation, having offset and possibly even caused the slight decline in private saving during the 1980s.
- Australia's deregulated financial system confers greater freedom for intertemporal transfers through saving behaviour, but does not distort the choices which individuals make about these matters.

### 17.5.1 Components of aggregate saving

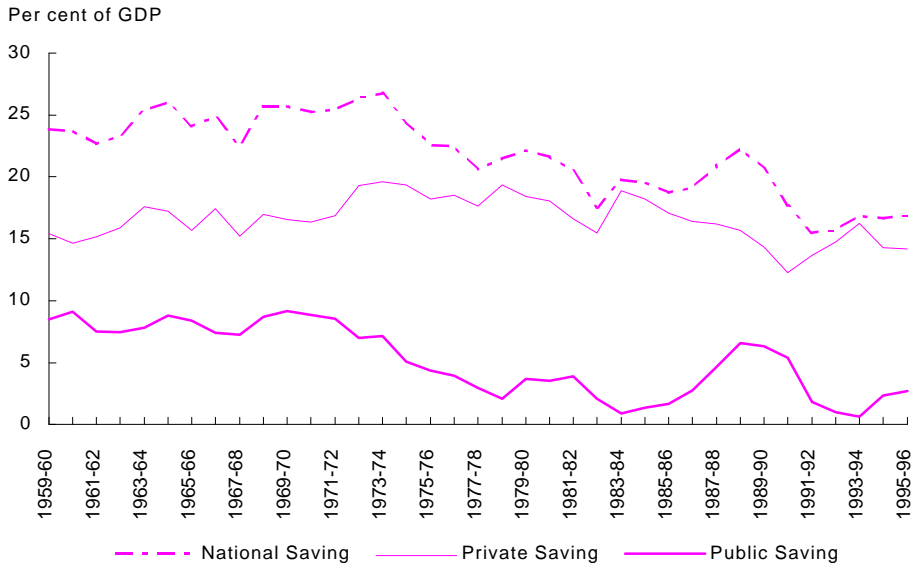
In Australia there was a marked decline in national saving as a proportion of GDP between the early 1970s and the early 1990s. This decline started before financial deregulation and has continued after deregulation. It is evident from Figure 17.9 that the long-term decline in national saving is due mainly to a decline in public sector saving. The dominant factor is a trend deterioration in the underlying budget balance of Commonwealth governments.<sup>43</sup>

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43 FitzGerald 1993, pp. 27-35.

***The Public Sector has been  
the Main Factor in the Decline  
of National Saving...***

Figure 17.9: Components of National Saving



Source: ABS 1996, Cat. no. 5204.0.

There has been a gradual trend decline in gross private saving since it peaked in the mid-1970s. Gross private saving is the sum of household saving (which includes saving of unincorporated enterprises) and corporate saving (by incorporated trading and financial enterprises). Since the owners of incorporated enterprises have considerable discretion to keep savings in their businesses or in their own hands, movements in the two component series may offset each other, and they are best viewed as interrelated rather than distinct. The household saving component has declined substantially, while the corporate saving component has varied considerably (in association with the profit share and stages in the business cycle) around a slight rising trend.

## 17.5.2 Private Saving

It is reasonable to suppose that financial deregulation contributed to the slight decline in private saving. The removal of cross-border capital controls and intensified competition among financial institutions made credit more readily available to businesses and households. For those who were willing to pay the going price for borrowing, consumption and investment were no longer constrained by holdings of liquid assets. This greater access to credit may have disposed business proprietors and householders to see less need for savings balances for either transaction purposes or precautionary purposes.

That said, there are several considerations which should keep the down-trend in private saving in perspective:

- First, it cannot be attributed only to financial deregulation. The down-trend began in the mid-1970s and was well defined before financial deregulation. Moreover, it is probable that other factors contributed — especially tax incentives for borrowing, community perceptions formed by the social security safety net, and the experience of inflation in the 1970s undermining the value of financial savings.<sup>44</sup>
- Secondly, it may be a better interpretation to adjust the data for the effects of inflation. The component of interest which represents maintenance of the real value of loan principal is substantial when inflation is high, and its value has varied with changing rates of inflation. When private saving is adjusted for these inflation effects, the rate of decline is less unusual in historical or comparative terms, as Figure 17.10 shows.

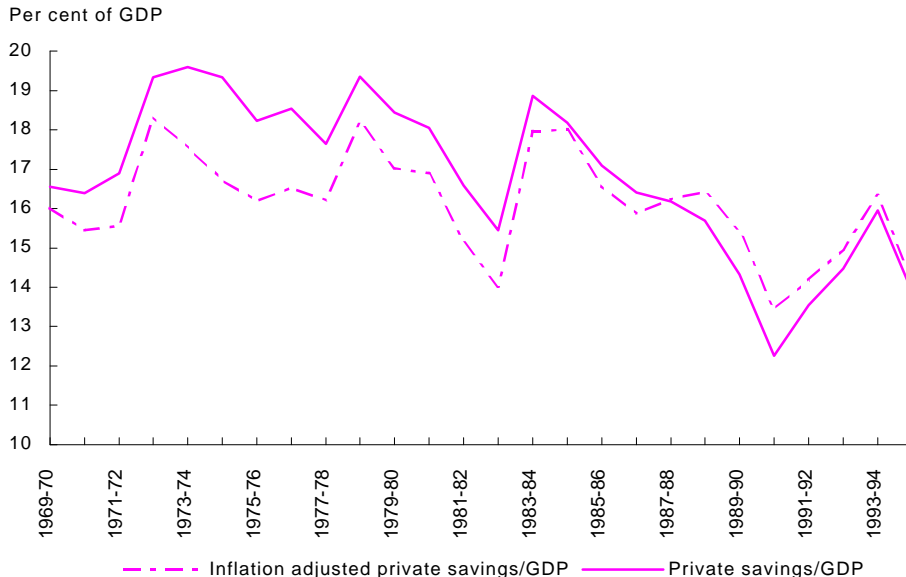
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44 For extensive analysis, including of other factors simultaneously affecting national and private saving, see Whitelaw & Howe 1992, Chapter 2.



**After Adjusting for Inflation,  
there has been Less of a Decline  
in Private Saving . . .**

Figure 17.10: Inflation Adjustment of Private Saving Ratio



Source: Estimates by the Commonwealth Treasury, using the procedure described in Bartley & Phipps 1995.

- Thirdly, evidence from other countries in which financial deregulation was associated with substantial falls in household saving (notably the United Kingdom and some of the Scandinavian countries) suggests that the effect of deregulation on household saving has been only temporary and saving ratios have largely recovered.<sup>45</sup> In Australia, there has been no clear recovery of the private saving ratio as yet.
- Fourthly, according to analysis undertaken in 1995 by EPAC, the present level of private saving, if combined with an historically more normal level of public sector saving, could finance enough

45 Edey & Hviding 1995, p. 17; cf. Andersen & White 1996, pp. 63-65.

investment to continue satisfactory growth of GDP and living standards, without recourse to foreign savings.<sup>46</sup>

- Finally, part of the explanation of lower private saving during the 1980s may lie in the relatively rapid growth of net private wealth. This is described in the next section.

In summary, the gradual decline in private saving since the 1970s does not appear to be strongly associated with financial deregulation.

### 17.5.3 Private Net Wealth

During the 1980s and (so far) the 1990s, net private sector wealth in Australia (shown in Figure 17.11) has increased in real terms more rapidly, on average, than in the previous decades of the 1960s and 1970s.<sup>47</sup> The average annual growth rate during the 1960s and 1970s was 3.4 per cent. During the period from 1980 to 1996, it was 4.0 per cent.

One important conclusion which can be drawn from these estimates is that the net wealth of the Australian private sector has not declined notwithstanding the increases in foreign ownership and foreign indebtedness which followed financial deregulation and the opening of the Australian economy. On the contrary, private sector wealth has increased, at an accelerated rate.

The unusually rapid increase of net private sector wealth from 1984 to 1989 was due in large part to the boom in asset prices mentioned above in Section 17.2.3. However, even taking into account the correction in 1990 and 1991, there has been an impressive long-term increase in real asset prices during the period since deregulation. This can be seen in part as an adjustment of domestic asset values to those in the rest of the world, which took place when the deregulated system allowed greater freedom for foreign investors to buy Australian assets and so to bid up their prices.

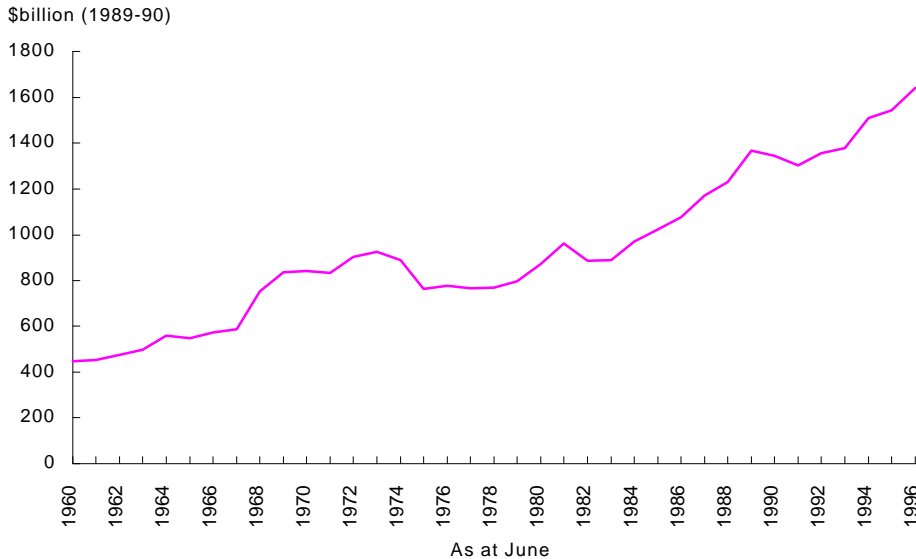
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46 EPAC 1995, *Investment and Economic Growth*.

47 These estimates of wealth reflect net ownership of domestic and foreign assets by the Australian private sector. The Commonwealth Treasury, which compiles them, notes that they depend on a number of assumptions and approximations, and represent indicators of trends and broad orders of magnitude rather than precise estimates.

## ***Private Wealth has Risen more Rapidly since Deregulation . . .***

Figure 17.11: Real Net Private Sector Wealth at Market Value



Source: Department of the Treasury 1997, Table 1(b), p. 70.

This unusually rapid accretion of private sector wealth may also contain a partial explanation of the trend in private saving mentioned above. Portfolio theory suggests that unusually rapid wealth increases through capital growth would justify a fall in saving out of income streams.

### **17.5.4 Framework for Saving Choices**

The problem of a large, persistent current account deficit has been a concern to a wide range of Australians including some financial and economic experts. This concern is linked to a widespread perception that Australia does not save sufficiently.

Financial deregulation removed a (liquidity) constraint from household borrowing. At the same time the evolution of international capital markets reduced constraints on national borrowing. This produced, at both household and national levels, a more accommodating framework; but that

is all. Provided the financial system reflects without distortion the fundamental incentives and disincentives which surround choices about consumption, saving and investment, there can be a presumption that the outcomes reflect the rational choices of all the participants and that intervention is not justified.

The proviso that incentives and disincentives should be accurately reflected is important. At the level of individual borrowers it requires that credit be correctly priced. At the macroeconomic level it requires that financial markets incorporate assessments of indebtedness and economic policies, and that they react rationally.

A low saving ratio reduces the capacity for Australian savings to support investment in Australia. Opening the Australian economy to international capital inflows meant that investment in Australia continued at levels that were warranted by prospective risk adjusted returns viewed in a global framework. The shortfall between investment and domestic savings was financed to the extent necessary by foreign savings. In this way, deregulation almost certainly helped to maintain capital formation and economic growth in the short term.

However, in a longer time frame, a low saving ratio with given levels of investment and GDP growth implies:

- increasing indebtedness or foreign ownership of Australian resources; and
- a need for a progressively stronger trade balance to service this rising foreign debt or equity.<sup>48</sup>

There has been wide debate about whether or not Australia's reliance on external capital has created a long-term problem. One source of evidence of a problem would be if Australia's aggregate indebtedness were to add a country risk premium to the cost of current foreign borrowing (as distinct from a forward exchange rate discount reflecting currency risk). There is debate about this. RBA research suggests there is no observable country risk

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48 There is extensive analysis of this issue in Chapter 3 of Whitelaw & Howe 1992. See also Bullock, Grenville & Heenan 1993, especially p. 120, and EPAC 1995, *Investment and Economic Growth*.

premium. However, some other researchers find a small country risk premium (around 25 to 50 basis points) which has applied since the early 1990s, after the downgrading of Australia's long-term debt ratings by international agencies in 1989.<sup>49</sup>

In summary, a deregulated financial system confers greater freedom for intertemporal transfers through saving and borrowing, from individuals through to nations. It also contains the information and price mechanisms through which household, sectoral and national saving ratios can be restored in the long term.

## 17.6 Growth and Employment

As noted in the introduction to this chapter, the Inquiry considers it impossible to define with any reliability the alternative outcomes for aggregate growth and employment that Australia might have experienced in the absence of financial deregulation.

However, some broad inferences can be drawn about the probable implications of financial deregulation for allocative efficiency, external adjustment, monetary policy and saving.

In the long run, growth in the Australian economy is the result of increases in inputs of productive factors (notably capital and labour) and increases in productive efficiency. Therefore, to the extent that financial deregulation has increased the Australian economy's access to capital or its allocative efficiency more than would have been the case with alternative policies, it can be regarded as having increased the economy's growth potential.

This likely positive impact in the long run has been offset to some extent by transitional costs and investment mistakes made in the early years after

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49 Blundell-Wignall, Fahrer & Heath 1993, pp. 47-50 & 73-74; Applegate 1993, pp. 14-17; FitzGerald 1993, pp. 11-12; Douglas & Bartley 1997, pp. 14-20. It should be noted that key measures of Australia's indebtedness, such as net debt servicing cost as a percentage of exports of goods and services, have fallen during the 1990s.

deregulation — although it is by no means certain that such mistakes would have been avoided in a more regulated setting.<sup>50</sup>

The impact of financial deregulation on long-term employment, if any, is likely to have been through its impact on economic growth rather than through any direct linkage. The problem of high unemployment began in the 1970s, well before financial deregulation. It is generally regarded as attributable more to structural factors, on the supply side, than to deficiencies on the demand side where financial deregulation had its main impact. The explanatory factors include labour market features, education and training, technology changes, and social security arrangements. Financial deregulation may have contributed to an acceleration of structural change in the economy — that is probably one corollary of greater allocative efficiency. But that by itself is not a cause of higher unemployment, other than through short-term frictional unemployment.

Some public comment about unemployment has had a short-term focus, expressing concern that during periods when fiscal or monetary policy is tightened, employment is reduced or prevented from growing normally.<sup>51</sup> Because the need for macroeconomic adjustment has been ascribed to the discipline of exposure to international economic and financial pressures, it is understandable that financial deregulation has been viewed by some as the ultimate source of unemployment.

The Inquiry believes the better interpretation is that while financial deregulation has changed the methods of macroeconomic adjustment, it has not created the underlying need for such adjustments. In several respects, adjustment policies have been more effective and responsive since deregulation. There is no reason to believe that adjustment costs, including in employment, have been any greater under this approach than they would have been under a different policy approach.

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50 One interesting perspective sees a very long cycle of government deficits and leveraged, tax-assisted asset purchases which began in the United States in the mid-1960s, spread around the world and was brought under control only gradually during the 1980s. See, for example, Hogan 1994, especially p. 48, and Macfarlane 1997. In this perspective, the transition costs following financial deregulation may be one of various ways in which largely inevitable long-term corrections have been or are being made.

51 See, for example, Argy 1996, p. 13.

## 17.7 Other Changes Attributed to Deregulation

This chapter has addressed only the more obvious and substantial macroeconomic implications of financial deregulation. Numerous other ideas have been expressed in submissions to the Inquiry and in the writings of economists about the direct and indirect effects of financial deregulation in Australia.

Many of these ideas associate financial deregulation with other, broader trends — for example:

- the pressure which financial markets are said to have exerted on governments to reduce the size of the public sector and privatise publicly-owned assets, especially major infrastructure;
- deregulation of labour and product markets and resulting changes in wage and income distribution;<sup>52</sup>
- changes in the rural economy and rural life, associated with difficulties in obtaining finance on suitable terms or seeing bank branches withdrawn from country towns; and
- acceleration of the adoption of labour-shedding technology, causing unemployment.

Not many of these arguments specify clear processes of cause and effect, or describe what might realistically have been expected to happen if policies other than financial deregulation had been followed. This makes it difficult to analyse them as propositions about changes in the macroeconomy. Where the Inquiry has identified in these arguments a current issue about a specific feature of the financial system or its regulation — for example, the provision of debt or equity finance to SMEs — the issue has been addressed elsewhere in this Report.

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<sup>52</sup> See, for example, Saunders 1993.

## 17.8 Concluding Comments

A central tenet of the Campbell Report was that a more competitive and efficient financial system would lead to a more vibrant and productive real economy. The assessment of this Inquiry is that such a change in Australia's economy has indeed happened during the past 15 years — but since many other factors have had concurrent effects on the economy, it is difficult to draw definitive conclusions about the impact of financial deregulation.

One clear advantage is that monetary policy has become more effective in the way intended when governments here and overseas embarked on financial deregulation. The period since deregulation has seen some improvement in the RBA's capacity to hit its inflation targets. There is no question that inflation in the 1990s is both lower and more stable than inflation in the 1970s. This has contributed substantially to macroeconomic performance and GDP growth.

Beyond this, the conclusions which can be drawn are inferential.

- The freeing of formerly controlled interest rates should have led to a better allocation of resources, which should have led to a more productive economy.
- The removal of credit rationing in the banking sector should have led to more efficient financing and pricing of production.
- Freeing of inward and outward capital flows should have increased the efficiency of investment in Australian industry, by widening the pool of potential investors, and the efficiency of investment of Australian capital, by widening the range of investment opportunities and facilitating diversification.
- As one of a set of changes which helped expose Australian industry to greater international pressure, financial deregulation should have encouraged reforms in the real economy.

While most of these outcomes appear to have occurred in Australia, it is evident also that many mistakes were made — some of them apparently costly — in the transition to a deregulated financial system. While these were not directly caused by deregulation, they were easier to make in a deregulated environment. It may even be that for much of the period since



financial deregulation, these transitional costs have predominated over improvements in allocative efficiency. However, during the 1990s the expected gains from improvements in allocative efficiency, brought about by financial deregulation, appear to have emerged more clearly. They are likely to predominate in the future.

While the balance of advantage from financial deregulation in its first ten years is debatable, it is clear that it was not the cause of Australia's main macroeconomic problems since the early 1980s. In particular, the persistent problems of high unemployment and low national saving are not closely bound up with financial deregulation. Net private sector wealth appears to have grown strongly notwithstanding the effects which financial deregulation may have had on foreign ownership and foreign indebtedness.

The Inquiry concludes that Australia's economic structure in the 1990s is more competitive, more flexible and more capable of coping with the pressures of the current decade than would have been the case without financial deregulation.