

# Financial Market Deregulation: A Case Study of the Australian Financial Markets

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The 'buzz phrases' of *segyehta*, globalisation and internationalisation, market access, market opening, financial market reforms and others are currently being debated within the Korean society. The Korean government and various participants in the finance industry, want to ensure that the opening of the economy, in particular the financial markets, does not lead to uncontrollable forces taking control of what has been, to date, a highly regulated sector and economy.

As Korea has entered into, and is currently debating, the direction and pace of the process of opening its various markets, it is often worthwhile examining comparable case studies of other economies to determine how it should (or should not) be done. The Korean government seems anxious to allow only an incremental and very gradual opening of financial markets in an effort to avoid or delay painful adjustment policies. In this paper, I would like to outline the progress of financial market reform in a relatively near neighbour and important trade partner, Australia, and highlight some important lessons that could be learned from its experience and indicate that the economic adjustments will, in all likelihood, be the same if a slower pace of reform is followed. However, the benefits of reform are likewise postponed, or could possibly be lost, if the pace of reform is insufficient.

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To begin, I will outline the process of financial market reform in the Australian context. In 1983, with the election of the Australian Labor Party to office, a review committee was established to examine the proposals of an earlier government committee formed under the former Liberal Conservative government, to examine the financial markets. The recommendations of the Martin Committee of Inquiry, which reviewed the previous committee's report (The Campbell Report) were implemented to a significant degree in the ensuing 1984 - 88 period. Since 1988, there have been some further adjustments to the financial markets and the regulations governing them, but essentially, most of the reform work was done in that brief four year period.

The pre-1980 era of Australian financial markets, was a case study in itself of government intervention in almost all facets of the financial markets. Restrictions were placed on interest rates that could be charged for mortgages, clear differentiation between which banks could do what and in what sectors, a monitored and centrally adjusted exchange rate, barriers to foreign investment and borrowing, cumbersome and slow-to-adjust banks and other financial intermediaries which needed to understand customer service and learn how to compete. All in all, Australia possessed an inefficient and uncompetitive financial sector barely able to manage with the meagre pace of growth in a medium-sized economy.

What followed 1983 was a rapid and momentous shift to a deregulated financial market. It would be laborious to repeat the reforms in detail, but in summation, interest rate interference was abolished, bank mergers permitted, the exchange rate floated, foreign investment and borrowing restrictions lifted and increased competition in banking - both retail and wholesale sectors - permitted with the introduction of 15 foreign banks into the wholesale financial services market.

By 1988, the financial sector reform was mostly completed and Australia

possessed a radically changed, raw and untested financial sector designed to facilitate growth in the economy into the 21st century.

So far, this sounds incredibly wonderful and painless. Well, it was not entirely painless, and not everything was wonderful. Remember, if it sounds too good to be true, it probably is, and in this case, it was. The reformed financial sector was harshly put to the test in the next five years. A great deal can be learned from what happened.

Firstly, with its new found freedoms, banks were unaccustomed to having so much room to maneuver. The banking sector's response to this freedom was to endeavour to increase asset size dramatically. Bank lending increased rapidly as banks took on higher risk lending in order to increase market share. The quality control aspect of lending activity, took second place to the urgent need to increase market share. Debt financing of the economy rose to unprecedented levels, in both the corporate and household sectors, due to the ease of obtaining credit and a tax system bias towards debt. In the corporate sector especially, debt, particularly foreign debt, was facilitated by banks and channelled into unproductive takeover and merger activity. 'High-flying' entrepreneurs and the corporate sector generally, were over-leveraged. Asset-inflation, helped by a persistently high inflation rate, and fuelled by bank lending, created an Australian 'bubble economy'. It became difficult for firms to attain finance for genuine new development or growth and venture capital was even harder to obtain.

A further effect of deregulation was on foreign indebtedness. Net foreign debt, including both debt and equity investment, ballooned during the 1980s and 1990s from AUD\$7bn (US\$5 bn) in 1980 to AUD\$181bn (US\$136 bn) in 1995. The servicing commitment on foreign debt has added crippling figures to the current account deficit (CAD). Australia, which had a history of relatively small current account deficits, has faced higher and protracted deficits through the 1980s and

1990s. Currently, the CAD is running at around 6% of GDP or around US\$21bn per year. This has fluctuated between 3% and 6% over the last decade. Numbers indeed, which greatly concerned the government and the Treasury.

The Australian currency, which was floated in December 1983, has been a difficult aspect of reform to handle. From a managed, pegged currency to a highly traded and volatile commodity currency is indeed, a big step. Despite Australia being responsible for only about 2% of world trade volumes, the AUD has been in the top six or eight traded currencies in the world since it was floated. This aspect of macroeconomic management has been a difficult variable to manage and it has produced many painful consequences in Australia. Currency volatility is a constant pressure on the economy as exporters and importers, manufacturers and service industries must be constantly aware of movements in the exchange rate and adjust to it. The volatility is not helped by the commodity based nature of our exports. This uncertainty has made investment decisions harder to make, with resultant effects on the level of investment overall.

Banks themselves, have endured very hard times. Unlike the Japanese financial system which has yet to bring to account all, most or even some of their bad or non-performing loans as a result of the 'bubble economy', Australian banks quickly adjusted their loan portfolios when all sectors, from high-flying entrepreneurs to mortgage lenders, went into default. Bad debt levels were unprecedented, profits plummeted and jobs were ruthlessly axed in an attempt to recover the situation. This ailment spread, of course, to other financial intermediaries and everyone from traders and clerks, to secretaries and chairmans of companies were affected by the sudden correction to the financial industry.

At this point, I would like to point out that the main cause of the economic downturn that precipitated this shakeout, was a policy induced recession. Faced with a mounting CAD crisis, the government was forced to push interest rates up

to the point where cash rates reached 18%. This deflationary policy was designed to draw demand away from imports and to 'dampen demand'. Imports were perceived to be the 'bogeyman' of the BOP problems. As was predicted by some and now seen by many, the BOP has remained stubbornly high and the real BOP 'bogeyman' continues to be interest and dividend repayments of foreign investment and debt, but it is not helped by a domestic reliance on imported goods.

Since 1992, there has been a recovery of the economy. Australia has enjoyed relatively robust growth (one of the highest growth rates in the OECD) but it is still constrained by the BOP and foreign debt shackles. The CAD has worsened and although foreign debt levels have stabilised, they are still at around AUD\$300 bn (US\$225 bn) in gross terms and AUD\$180bn (US\$135bn) in net terms.

The banking and financial sector as a whole has recovered profitability and their balance sheets are returning to normal. Banks and intermediaries have re-learned how to compete in a deregulated environment and have learned from the bitter experience of lending on speculative investment.

But what of the lessons from this experience? When the process of financial regulation was just beginning and all through its implementation, there were calls in Australian society for a slower pace of change: 'Don't go too fast, watch out for the curves, don't be so reckless'. You may conclude that Australia deregulated too quickly and too soon and should have taken a slower course of deregulation. They should have 'taken it easy' which is such a favourite axiom of Australian society. I would suggest that this is in fact not the right conclusion to take away from this study. The Australian case study was a model of allowing the market forces full reign. The consequences have been harsh, but fair. I argue, that a slower course of deregulation would not have avoided the subsequent market reactions of what happened.

One clear effect of deregulation in the Australian financial markets, is credit growth. During the 1980s, research has shown that credit growth far exceeded demand growth, as the economy actually changed its appetite for debt as a means of increasing corporate and personal wealth. This change in appetite and availability of debt fuelled the asset price boom of the mid to late 1980s and must also be responsible for the severe correction which followed. As we know from basic finance theory, a company which leverages itself, will enjoy higher returns than an unleveraged company in good times, but during recession, it will endure greater falls in returns and may eventually become bankrupt in a worst-case scenario. This fundamental theory proved to be all too correct.

Korea has the benefit of a strong export sector in sophisticated manufactures and significant overseas investment in many areas of the world. This is one of the major differences between the Korean and Australian economies and should be a helpful factor in the reform process. However, it does share a current account problem with Australia. The current account deterioration has become a major 'speed limit' on the growth of the economy as the government attempts to manage sustainable growth without 'blowing out' the current account. Australia's current account deterioration has been driven in part, at least, by foreign debt, exacerbated by the dominance of commodities (agricultural and resources) in the export equation. Current account management will probably figure much more highly in economic decision-making in Korea's future.

Another clear lesson for the banking sector, is the necessity of high-quality loan portfolios. The absence of quality control by Australian banks, as they fought for increased market share, and bigger asset size, was one of the salient lessons of deregulation. It is easy for banks to be tempted into taking on excessive risk in return for higher returns, but the reputation of banks, their financial integrity and their importance to the economy overall, are far more

valuable than the returns gained from high-risk lending. The Japanese and Australian banking systems, are cases in point.

As we are well aware, the international financial market probably represents one of the most truly competitive markets in the world economy. By competitive, I refer to the basic tenets of a competitive market: many competitors, supply and demand adjusting relatively quickly to market forces, information levels are particularly high and there are many homogenous products which can act in substitution. In an imperfect world though, the financial markets still are shy of our favourite neo-classical, laissez-faire model. However, it is a highly active and perceptive market. One that is not easily tricked and can rarely be outplayed. The market in finance is king. Arbitrageurs take care of that.

If you feel that the Korean financial market, and the economy in general, can escape from the effects of market deregulation, then there is little argument. I would suggest, however, that you must have some very good information which the rest of the market is not privy to. By spinning out the deregulation process to any number of years, the market is unlikely to be fooled. Waiting long periods until all companies 'come up to speed' with the international environment is not feasible. There is no similar discipline to that of the market which can be emulated inside a closed economy. There are many benefits to deregulation that can only be realised by fully taking part in the process.

Higher unemployment will be inevitable as companies have to become leaner and more efficient. For a country with a history of near full employment, this is a painful adjustment in itself. Unemployment is a feature of modern economies which has proved almost impossible to solve. Slowing the pace of deregulation will not change this inevitable outcome. If it takes 2 years, 20 years or 200 years, the market will be waiting and the consequences will be the same. Learning needs to be complemented by real experience.

Australia, after going through a painful readjustment process which cost jobs and income to its citizens, has overcome the hurdle of change and is in a far better position than before the reforms. It has transformed itself from an inward looking, sheltered, unproductive economy to a externally-oriented, competitive, regional power, but it is still bedevilled by problems. Currently, the economy is enjoying its fourth year of economic recovery and signs are that it will continue at a steady pace of around 3 - 4%. The pace of deregulation would not have changed the effects of financial deregulation one iota. In fact, it is unlikely that the economy would be growing at all without the reforms to the financial and other sectors.

The lesson to be learned is that deregulation needs to be done in the minimum time required. The argument should not be over methods, but outcomes. The benefits of deregulation are there to be taken - higher growth, a more efficient economy and better market outcomes. Of course, there are costs which have to be managed, but if Korean citizens are informed and convinced of the benefits to their nation of deregulation, they will be prepared to partake in the reform process. By learning from other countries, pitfalls can be avoided and some aspects of the process can be better managed, such as avoiding the conditions for a 'bubble economy' and the maintenance of quality control in banks. The consequences may be delayed by a slower process of change, but the benefits are further delayed and may not be eventually be realised to their greatest possible extent.