

Australia's Transition from Crawling Peg to Floating Exchange Rate

Until recently Australia's foreign exchange arrangements were characterised by a degree of government regulation and control rarely found among countries with comparable financial structures. The exchange rate for the spot and forward Australian dollar was administered by the monetary authorities, foreign exchange dealing was restricted to a small exclusive group of authorised operatives, and the system was underpinned by comprehensive exchange controls which survived virtually intact from the early post-war years. Despite growing criticism, no new major initiative for change emerged until the publication in 1982 of the deliberations of the Australian Financial System Inquiry (the Campbell Committee). The Committee, having found widespread dissatisfaction with the regimented nature of the system and with the *ad hoc* manner with which it had been adapted to the changed circumstances of the post-Bretton Woods era, argued, *inter alia*, for a freeing of official controls over foreign exchange transactions.

These recommendations, however, were not acted upon by the Liberal Government of the day, and further developments had to await the pressure of events. In March 1983, the approaching Federal election sparked a speculative run against the Australian dollar, causing severe disruptions in the short-term money market and forcing the incoming Labor Government to suspend the crawling peg arrangement for setting the spot exchange rate and devalue the dollar by 10 per cent. By mid-year, a strong foreign reserve position and improved balance-of-payments prospects reversed the direction of speculative capital flows, threatening to blow out the Government's monetary target. Faced with two major crises within six months of assuming power, the Hawke Labor Government embarked in late 1983 on a course of de-regulation of the foreign exchange market along the lines recommended by the Campbell Committee.

The liberalisation of Australia's foreign exchanges has since proceeded at a rapid pace. In October 1983 the Reserve Bank abandoned

control of the forward market and effectively allowed the forward exchange rate to float. This was soon followed by the major step of floating the spot rate in December 1983 and by the removal of a large part of exchange controls. In April 1984 the virtual monopoly of the trading banks in foreign exchange was ended with the admission of some forty non-bank institutions as exchange dealers. And in September 1984, the Government announced a new set of guidelines for the entry of foreign banks into the Australian financial system, followed by a decision to grant banking licences to sixteen overseas banks in February 1985.

In our examination of this transition, primary emphasis is placed upon those factors which over the years eroded the regulated system's effectiveness in achieving the authorities' exchange rate and monetary objectives. Here the story is one of private sector financial innovation in overcoming the rigidities of the official system and circumventing the obstacles to capital market integration. We begin by outlining the regulatory framework.

The Regulatory Framework

In its essential elements, the Australian system had three characteristics which changed little during the period 1945 to 1983. These were: *exchange controls*, which governed the activities of all participants and served as a device for limiting the demands and supplies in the market; the *administered price system*, which was the mechanism for setting the spot and forward rates at levels determined by the authorities; and the *clearing mechanism*, by means of which the Reserve Bank balanced the demands and supplies in the private market within these constraints.

Unlike exchange controls of many countries, which permitted most transactions while making some subject to control, the Australian regulations forbade all foreign exchange dealings, unless they had the prior express approval of the Reserve Bank or its agents. Since the early 1980's the main aim was to limit Australians' freedom to hold foreign money balances and fixed interest securities. Non-residents were restricted to holding only minimum working balances in Australian dollars, and from borrowing in the local capital markets. Virtually all foreign exchange business was in the hands of a small select group of authorised dealers — essentially the four major trading banks — which

also acted as the Reserve Bank's agents in issuing exchange controls clearances on routine transactions. At the close of each working day, the trading banks were obliged to settle their net currency positions (in excess of permissible working balances) with the Reserve Bank at the posted official price — the US/Australian dollar mid-rate. In effect, the Bank acted as the market-maker at the official price. Since virtually all flows across the exchanges were thus absorbed in the Bank's stock of foreign reserves, its activities were tantamount to *total intervention* in the foreign exchange market.

Parallel provisions governed the operation of the 'official' forward market — so called because of the Bank's role as the dealer-of-last-resort in providing forward cover for approved purposes. Along with fixing the US dollar spot rate, the Bank each morning quoted to the trading banks rates (buy and sell up to six months ahead) for forward cover in US dollars at which it stood prepared to deal with the banks during the day, with the banks in turn using these margins as the basis for their own forward quotations to customers.

While the residual clearing by the Bank on the spot account was of crucial importance in influencing monetary outcomes through its impact on the economy's monetary base, the operations on the forward account influenced, in the first instance, the Bank's 'forward book', that is, its net 'oversold' or 'overbought' position in forward exchange, and hence the size of the exchange risk it carried on its forward commitments to the trading banks writing forward contracts with their customers. Largely to limit the size of that risk, only firm commitments to specific transactions in foreign currency at some definite future date, related to trade and supported by documents, were eligible for cover. As the Bank's forward book lengthened, the eligibility criteria for entry tightened. In 1972, non-residents were excluded; and from June 1974, Australian traders could take out forward cover only if they applied within seven days of first incurring the foreign exchange risk.

Paradoxically, this restricted access to the forward market occurred at a time when the needs of the private sector to cover exchange risks on a routine basis were expanding rapidly due to changes in the method of fixing the value of the Australian dollar. Following the breakdown of the Bretton Woods system in 1971, Australia at first clung to the idea of a fixed exchange rate by switching, initially, from the traditional parity with sterling to a direct link with the US dollar and then to a fixed trade-weighted link, whereby the value of the Australian dollar was held fixed against an undisclosed basket of currencies chosen

and weighted according to their trading significance to Australia. Only in 1976 did Australia belatedly join the flexible exchange rate world by switching to a trade-weighted 'crawling peg' currency index.

The Crawling Peg: Australian Version

Instead of holding the trade-weighted index at a given level, as under the fixed trade-weighted link, the authorities now had the option of varying it by small and frequent steps in accordance with their perceptions of what the effective, or trade-weighted, value of the Australian dollar should be in the light of changing circumstances. The US dollar mid-rate, declared daily on the basis of overseas currency movements (the 'basket effect') and adjusted for the discretionary shift in the trade-weighted index (the 'policy effect'), continued to provide the basis for the inter-bank and the public buying/selling rates for US dollars, other rates being determined by the banks themselves by reference to third-currency cross rates. The forward regime remained essentially unchanged. This was the system which prevailed until December 1983.

The new arrangement was described at its inception as a 'flexibly administered rate, somewhat along the lines of a managed float',¹ thereby giving the impression that Australia had finally abandoned its heavily managed system in favour of a float. It had not, and the difference was not in the extent of day-to-day variation in the exchange rate but that the rate was moved entirely at the discretion of the monetary authorities. Rather, what did find reflection in the new system was the Treasury view that 'policy objectives should, as a matter of principle, dictate the appropriate exchange rate arrangement; not vice versa'.²

Broadly, these policy objectives were, first, to use the exchange rate as an instrument of economic policy (i.e., for both internal and external balance); and second, to smooth the effects of disturbances on the world exchanges (i.e., to correct perceived market failure). In the former

¹ Statement by the Treasurer, the Hon. Philip Lynch, 28th November 1976 (Treasury Press Release No. 217).

² TREASURY, 1979, p. 23.

role the flexible link permitted 'trending' of the effective exchange rate over time to provide support for the government's overall policies (for example, to alter trade competitiveness, or to bear against inflation by lowering the domestic cost of imports); in the latter it could be used to dampen the effects of sudden jumps in overseas currency rates on the US/Australian dollar mid-rate by offsetting movements in the trade-weighted index.

A principal difficulty with the Australian form of the crawling peg was its very complexity, which did not always allow market observers to form clear judgments as to how overseas currency movements and policy decisions were transmitted into actual currency values. There were in fact two indicators of Australia's exchange rate — the trade-weighted index and the US/Australian dollar mid-rate. Although these were related in the complex formula applied daily by the Reserve Bank, they did not necessarily move in the same direction. For example, during 1981 and 1982, the index was moved steadily upwards, indicating a strengthening exchange rate, but the movement was not sufficient to offset the rise of the US dollar (the largest component in the index along with the Yen) in overseas markets, so that the initially strengthening trend in the key US/Australian dollar mid-rate became reversed, giving an impression of an opposite development. If by adopting the crawling peg the authorities had hoped to give economic agents clear signals as to the direction of exchange-rate policy, it is by no means clear that they succeeded.

These problems notwithstanding, the crawling peg added to the flexibility of the spot market and, at least in the initial stages, presented a reasonable compromise between 'fixing' and 'floating'. Where the problem lay in the late 1970s, as far as the private sector was concerned, was in the unsatisfactory state of the 'official' forward market. By controlling tightly entry into the market, the Australian authorities had hoped to avoid the monetary problems associated with volatile capital flows; more specifically, they wished to avoid the implications of world interest parity for the structure of Australian interest rates. For precisely this reason, cover in the official market was not available for 'pure' financial arbitrage with overseas markets, or for speculation. With Australian residents being severely restricted in the amounts of money balances and fixed-interest securities they could hold abroad, the opportunities for covered arbitrage were confined to 'borrower' arbitrage, coming from trade transactions. But as Australian interest rates tended to lie above those ruling overseas, and often by substantial

margins, there was generally strong incentive for Australian borrowers to tap lower-cost sources of overseas finance, although with varying degrees of exchange risk since the borrowings could not be covered in the official market. So as to maintain a tight grip on any form of arbitraging with cheaper overseas markets, the authorities from time to time enforced the already stringent provisions for entry into the forward market by additional controls on inward capital flows. For periods of time, embargoes were placed on short-term foreign borrowings (other than for normal trade-financing activities), and the effective cost of overseas funds was raised by applying a variable deposit ratio requirement (i.e., placing a prescribed proportion of the loan in a non-interest bearing account at the Reserve Bank for periods depending on the terms of the loan).³

Powerful incentives were thus created for the development of surrogate hedge markets in Australia, which would bypass the official facility underwritten by the Reserve Bank. By first acquiescing in the creation of such markets, the authorities tacitly, though perhaps not willingly, contributed to a fragmentation of the forward market in Australia; and later, as the alternative facilities grew in significance, they progressively lost control of the mechanism intended to shelter the domestic monetary sector against the disturbances of international capital flows. In both respects, the growth of private hedge markets was an important catalyst in the process of change which culminated in the de-regulation of the exchange markets in late 1983.

Market Innovation: The Hedge Markets

The private hedging facilities which developed in Australia during the 1970s were all based on the principle of 'offsetting risk' – an example of the 'mutuality' principle of insurance.⁴ The legal vehicle was the 'mutual indemnity contract'. Under such a contract, two parties (either exporter/importer/borrower) with an equal but opposite foreign exchange risk agreed to indemnify each other. The party benefiting from an exchange rate movement would compensate the party losing, and in this way the open position of each party was hedged.

³ See DAVIS and LEWIS, 1980, Table 5.1.

⁴ See MARSHALL, 1974.

In 1975, the Reserve Bank gave its formal approval to these arrangements, subject to one important condition: in the settling of such contracts the Australian dollar was to be the exclusive currency of settlement. This meant that the hedge contracts themselves needed no exchange control approval. But it also meant that the private hedge contract was a 'non-delivery' contract, in the sense that no foreign exchange passed hands, only the Australian dollar equivalent of the net indemnity involved. After the hedge contract had been settled, the actual purchase or sale of foreign exchange had to be undertaken in a separate spot transaction through the authorised dealer network (and hence subject to prior exchange control approval). For example, an exporter who hedged a future US dollar receivable would have made a gain on the spot transaction if the Australian dollar had depreciated during the term of his hedge contract, but that gain would have been offset by a net indemnity payment to the opposite party, leaving the position of each party hedged even though the respective hedge and currency transactions took place in separate markets. These intricate arrangements evolved because the authorities were not prepared to grant the trading banks the freedom to develop a genuine spot-against-forward market in which forward margins would be based on interest differentials between Australian and foreign financial markets.

The market began with stockbroking firms and specialised brokers organising the pooling of exchange risks among Australian companies – the 'inter-company' hedge market. Merchant banks later entered the field initially as brokers and later as principals, i.e., writing hedge contracts on their own account with clients. As principals, the merchant banks needed to concern themselves less with matching hedge positions on a contract-by-contract basis, and this added greatly to the size and depth of the market. In 1979, the government permitted the trading banks to develop their own 'interbank' hedge market on the condition that their activities as authorised dealers and private hedge market operators would be strictly segregated. This was to prevent the banks from arbitraging between the official and private segments of the market, but at the cost of further fragmenting the Australian foreign exchange arrangements.

To market participants the rapidly growing private hedge market offered two main advantages: flexibility and versatility. None of the extensive documentation needed for the official market was required; the market was non-discriminatory with respect to the type of transaction, permitting foreign exchange exposures to be aggregated and

hedged on a net basis; and it resembled more closely a competitive market inasmuch as the hedge margins were more sensitive to changing market conditions. However, the official and private markets remained linked, as traders who were eligible for cover in the official market could switch their transactions and thus effectively arbitrage between the two. To this extent the Reserve Bank was able to influence hedge margins by the rates it set in the official market. At the same time, the authorities could no longer disregard market conditions in setting margins in their own regulated segment of the market. This found reflection in a growing tendency for Australian forward rates to approximate more closely the interest differential between local and world interest rates, although substantial covered interest margins opened up on occasions to the very end of the regulated system.

The Australian authorities valued the ability to manipulate forward margins. When policy considerations required that domestic interest rates be maintained above world parity, the authorities could raise forward premiums, creating an arbitrage gap unfavourable to overseas borrowing and, by doing so, keep domestic financial conditions tight. To the extent that the premiums spilled over into the hedge market, this policy would have discouraged overseas borrowing generally. But by granting the private sector the freedom to conduct its own market, which they had effectively created by their own actions, the authorities could no longer stop the process of integration of the Australian and overseas financial markets. Increasingly, Australian interest rates had to be subordinated to the state of the capital account in the balance of payments. International financial integration, of course, had proceeded rapidly in other parts of the world after the restoration of convertibility in the late 1950s. But the 'Australian model' of exchange rate regulation continued to be based on the premise that Australia was a 'special case', with the implication that exchange and capital controls could be relied upon to shelter the economy from destabilizing international capital flows, and at not too high a cost. That judgment proved erroneous.

International and Financial Integration

In its submission to the Campbell Committee in late 1979, the Australian Treasury laid much stress on Australia's 'isolation', 'relatively low degree of financial integration', and 'natural protection from the

impact of greatly increased international mobility of capital' (Treasury, 1979). Although integration is not easily measured, some evidence may be gleaned from three sources: the changing structure of Australia's capital inflows, the impact of external transactions upon domestic liquidity, and the linkages between domestic and foreign interest rates.

As a net importer of long term development capital, Australia traditionally relied on direct investment as the chief source of foreign investment. This pattern began to break in the mid-1960s as project financing of the country's export-oriented resource developments lent itself more readily to institutional financing, mainly borrowings in the rapidly growing Euro-dollar market. During the 1970s, due to the various restrictions outlined earlier, the proportion of portfolio investment and institutional borrowing in total inflows was kept low. In 1979-80, the proportion stood at 30 per cent; by 1982/83 it trebled to almost 90 per cent of total foreign investment in Australian enterprises during that year.⁵

The explanation for this extraordinary change in the pattern of external financing lies mainly in the economic impact of the second oil crisis upon the Australian economy. The crisis spawned a huge investment boom in resource-related projects. With the domestic capital markets lacking the resources to sustain a boom of this size, it became common practice for Australian semi-governmental authorities and even middle-size private enterprises to access overseas financial markets on a regular basis to raise loan capital, strengthen their financial structures, and regulate their foreign cash flows.

These developments are clearly reflected in the growing impact of external transactions upon domestic liquidity (Table 1). The Table shows quarterly movements in the volume of money (M3) and the contribution of private foreign exchange transactions (PFET) and domestic credit expansion ($DCE = M3 - PFET$). Although an inverse relationship between the two is evident, such a pattern is consistent with either of two possible hypotheses: first, that the authorities take action to moderate the effects of external monetary shocks upon liquidity, or second, that capital flows offset any attempt by the authorities to conduct domestic monetary policy independently of world monetary conditions. Econometric estimates (Porter, 1974; Murray, 1978; *et alia*) indicated an Australian 'offset' coefficient ranging between 0.7 and 0.3.

⁵ For details see POLASEK and LEWIS, 1985.

TABLE 1

DOMESTIC CREDIT AND PRIVATE SECTOR FOREIGN EXCHANGE
TRANSACTIONS, 1977-1983
(quarterly, seasonally unadjusted)

| Quarter: | Changes in M3 | | Private Foreign Exchange Transactions \$ Million (3) | Domestic Credit Expansion \$ Million (4) = (1) - (3) |
|----------|---------------|---------------------------|--|--|
| | \$ Million | Per cent per Annum (a) | | |
| | (1) | (2) | | |
| 1977 1 | 990 | 13.6 | 344 | 646 |
| 2 | -1,120 | 11.0 | - 30 | -1,090 |
| 3 | 763 | 7.5 | - 900 | 1,663 |
| 4 | 1,631 | 6.2 | - 313 | 1,944 |
| 1978 1 | 1,067 | 6.3 | 39 | 1,028 |
| 2 | - 575 | 8.0 | - 28 | - 547 |
| 3 | 1,837 | 10.7 | - 347 | 2,184 |
| 4 | 1,755 | 10.6 | - 292 | 2,047 |
| 1979 1 | 1,500 | 11.4 | - 27 | 1,527 |
| 2 | - 466 | 11.8 | 412 | - 878 |
| 3 | 1,396 | 10.2 | - 122 | 1,518 |
| 4 | 2,494 | 11.5 | - 111 | 2,605 |
| 1980 1 | 1,642 | 11.5 | 470 | 1,172 |
| 2 | - 147 | 12.3 | 730 | - 877 |
| 3 | 1,909 | 13.0 | - 73 | 1,982 |
| 4 | 2,786 | 13.0 | 870 | 1,916 |
| 1981 1 | 1,226 | 11.7 | 655 | 571 |
| 2 | 307 | 12.7 | 1,351 | -1,044 |
| 3 | 1,576 | 11.5 | - 792 | 2,368 |
| 4 | 2,595 | 10.6 | - 136 | 2,731 |
| 1982 1 | 1,180 | 10.3 | 416 | 764 |
| 2 | 933 | 11.3 | 2,971 | -2,038 |
| 3 | 1,760 | 11.3 | 359 | 1,401 |
| 4 | 2,554 | 10.8 | 1,999 | 555 |
| 1983 1 | 2,323 | 12.4 | - 75 | 2,398 |
| 2 | 1,102 | 12.5 | 1,588 | - 486 |

(a) Change on same quarter a year earlier.

Source: COMMONWEALTH OF AUSTRALIA, *Budget Papers*, Statement No. 2, (various).

Averaged, this would suggest that, at given exchange rate, about half of the impact of any tightening in domestic credit would have been offset by flows of international capital. These estimates pre-date Table 1, which indicates the emergence in recent years of a very pronounced inverse pattern between PFET and DCE in the 2nd (June) quarter (Australia's 'tight' liquidity quarter because of the timing of government tax collections). If Australia was becoming more closely linked to capital markets overseas, one would expect to observe movements of funds responding to seasonal differences between markets in the demand and supply of funds. These movements would ensure closer correspondence of interest rates in the two areas.

How closely interest rates in Australia are related to overseas interest rates has been investigated by a number of studies (Juttner, 1981; Carland and Valentine, 1982; Sharpe, 1983; Turnovsky and Ball, 1983). While making different allowances for the risk and liquidity characteristics of domestic versus foreign assets and using different measures of exchange rate expectations and hedging costs, the broad consensus of these studies is that Australian interest rates were not closely related to overseas interest rates in the 1960s and early 1970s, a period during which the authorities' control devices seemed relatively successful in insulating the domestic market from foreign influences. Thereafter, the relationship became much closer, albeit with lags and with occasional substantial deviations from covered interest parity.

Overall, the evidence points to a marked acceleration of Australia's financial integration with the rest of the world in the early 1980s. By then the private hedge market had grown in sophistication, despite the complexity of the settlement procedure, and began to surpass the official market in size and in the range of transactions. Increasingly, the authorities found it difficult to defend the Australian monetary fortress with their traditional weapons of prohibition and restriction. At the same time, the inadequacies of the crawling peg for the spot rate, which had remained overshadowed during the 1970s by other shortcomings of the system, became more apparent as the spot rate arrangements failed to keep pace with rapid developments elsewhere. The inconsistencies which emerged between the controlled spot market and the relatively free private hedge market further hurried along the end of the administered system.

Difficulties with the Crawling Peg

The wider channels for engaging in financial arbitrage, made possible by the rapid development of the private hedge market, also broadened the scope for speculation against the Australian dollar. By clinging to the apparatus of controls, the authorities tried to regulate the process of financial integration sufficiently to give the government scope to influence the path of the exchange rate. The vehicle for this was the crawling peg mechanism.

But as market operators gradually began to penetrate the mystique with which the authorities deliberately surrounded the complex mechanism for setting the daily spot rate, they also became more adept at taking up speculative positions against the authorities. As remarked above, the setting of the US/Australian dollar mid-rate could be decomposed into two elements: the 'basket effect' arising from movements of the US dollar against the basket of currencies making up the trade-weighted index; and the 'policy effect' stemming from the setting of the value of the index (the effective exchange rate). The basket component of the daily change in the mid-rate was based predominantly on exchange-rate quotations ruling at the close of business in New York. Because of the difference in time zones between Sydney and New York, that information was available for the Reserve Bank to assess each morning. But during the course of the Australian working day, business took place in the Far Eastern centres with similar time zones, and intra-day quotations from these centres enabled operators in Australia to gauge likely conditions in New York and thus the basket component of next morning's mid-rate declaration in Australia. Trading results in Bahrain, London and New York during the Australian night could be used to verify those predictions. Admittedly, there was also the 'policy' component of the trade-weighted index setting to judge, but once speculative positions had built up, the authorities had little option but to move the trade-weighted index in a fairly predictable way.

Eventually it was speculation which dealt the *coup-de-grace* to foreign exchange regulation in Australia. Because during the 'resources boom' Australian firms and financial intermediaries had built up substantial amounts of foreign debt, which could be re-arranged in accordance with prevailing spot-rate expectations, there was a large pool of potentially volatile funds which could be shifted fairly rapidly across the exchanges. In March 1983, for example, an estimated \$ A 3

billion left the country in the run-up to the Federal election, causing disturbances in the short-term money market verging on panic. In an opposite development in December 1983, an equivalent of \$ 1.5 billion of foreign funds was 'booked' by operators for transfer to Australia in something like nine days in anticipation of yet another one-off adjustment (revaluation) of the Australian effective exchange rate. In this respect, it could be said that the 10 per cent devaluation in March 1983 'broke the rules', destroying credibility for future operations and making transition to floating inevitable.

But these episodes were only symptomatic of the longer-term difficulties inherent in the administered spot-rate system. Over the years a tradition had been established of allowing the index to 'crawl' daily by only one or two index points. Yet once market expectations began to outstrip the 'very gentle, sometimes almost imperceptible, adjustments' in the trade-weighted index the disturbances to domestic policies, which became the cost of the system, were much too great to bear.

It is probably fair to say that the administered system of setting the spot rate did serve Australia reasonably well when the country's foreign exchange institutions were in their formative stages. One cannot float the exchange rate successfully unless there is a sufficiently deep market for it to float in. Indeed, one of the most frequently heard post-float complaints was that the market had difficulties in coping with large and 'lumpy' transactions; and to the very end, the hedge market for longer maturities remained very thin. But a much more serious structural fault in the entire conceptual framework was that in the pursuit of desirable macroeconomic objectives the authorities should see fit to impose upon the financial community a system of exchange controls that would have been more appropriate for a war-time economy. With the advent of more flexible exchange rates worldwide, hopes had risen in Australia that the controls would be progressively relaxed. Instead, the authorities turned the clock back by tightening restrictions further. For those traders who, by the nature of their business, could not meet the strict rules of entry into the official forward market, the new restrictions meant that they could not hedge their exchange risks at all. Non-residents, who might have been willing to invoice their Australian trade in Australian dollars, thereby providing local traders with the most natural hedge of all, were unceremoniously pushed out into fringe off-shore markets for the Australian dollar, which were unsatisfactory because of their lack of depth. The vacuum that was thus created in the forward market was much too great not to be filled, for once traders

discovered that they could hedge their risks, albeit in a roundabout fashion, on the mutuality principle, it was only a small step to use the new facility to cover capital risks. This widened the interface between Australian and overseas foreign markets rapidly, and provided scope for capital flows damaging to domestic monetary management. In order to liberate monetary policy from the constraints imposed upon it by the exchange rate, the crawling peg had to be given up and with it the plethora of the now useless controls. But because of perhaps a decade of retarded development, the process of transition had to be rapid, and in the concluding section we briefly survey the developments.

The Brave New World of Floating

In terms of adjusting to a market-oriented foreign exchange system, the Australian float can be regarded as a success. In October 1983, along with granting freedom to the banks to set their own forward rates on the basis of spot-against-forward transactions with overseas markets, the Reserve Bank altered the procedure for setting the US dollar mid-rate by quoting only an indicative rate each morning and settling with the banks at the closing official rate for the day.

This, however, was only a cosmetic improvement, for the speculative inflows in anticipation of a substantial revaluation continued unabated, and the interim arrangement was replaced with a full float in December. The first few weeks saw large buy/sell spreads on the spot US dollar, but the margins narrowed considerably as the banks had no difficulty in clearing the market within their currency limits, and by mid-January they were broadly comparable with those ruling overseas. The US mid-rate remained fairly volatile, especially in the weeks preceding the normal June quarter liquidity run-down, but there was a gradual settling down so that by about mid-1984 the daily and intra-daily variations did not appear markedly out of line with overseas experience.

At the time of floating the Reserve Bank announced that it intended to conduct a 'lightly managed float', with a right to intervene sporadically to 'test' the market and smooth out the effects of large transactions. Apart from 'technical' intervention of selling its previously acquired forward exchange commitment of about US \$ 300 million in the spot market, the Bank undertook net sales of foreign exchange for 'testing' and 'smoothing' purposes during the disturbed March quarter

of 1984 (Reserve Bank of Australia, Annual Report 1984, p. 13). These transactions, however, were light, and in its early stages the Australian float appears to have been a 'clean' one.

The main concern with the fledgling floating system was the alleged thinness of the market attributed by many participants to the small number of local banks operating as authorised dealers. Responding to that criticism, the government in April 1984 announced that initially forty new dealer licenses would be granted to non-bank financial intermediaries satisfying certain conditions governing capital requirements and standards of expertise. The trading banks were released from their past responsibilities as agents of the Reserve Bank in the administration of foreign exchange controls, and were thus placed on the same footing as the newly licensed non-bank institutions. More important, the prohibition upon the banks offering forward cover on capital transactions was lifted, thus removing the long-standing barrier to comprehensive covering of foreign exchange risks in the forward market. Surprisingly, these moves have not led to a rapid decline of the seemingly superfluous hedge market, as had been widely expected. With the activities of many of the smaller institutions centered on the old hedge market, the 'deliverable' foreign exchange business has continued to be dominated by the local trading banks and a very small number of non-bank intermediaries. With the admission of sixteen foreign banks, announced in February 1985, increasing competition may result in some further shaving of margins, but the initial impact of the new entrants is unlikely to be pronounced as most of the major overseas banks have already established their presence in Australia through affiliated merchant banks and representative offices. Where the most likely effect will be felt initially is in the area of financial innovation and in a further broadening of the interface between domestic and overseas financial markets.

In all major respects, the freeing of the Australian foreign exchange market and opening it to fresh winds of competition did not cause any major upsets, as predicted by some opponents of de-regulation. After initially strengthening against the US dollar, the Australian dollar declined moderately against the US currency, falling also slightly in effective terms. With a weakening balance of payments, the floating Australian dollar appeared to respond to the economic 'fundamentals' in a stable and orderly manner.

This period of relative stability ended abruptly with the events of February 1985. At the end of January, the spot rate stood at USD

0.8140 = AUD1. By the third week of February, it plunged to USD 0.6650 in the Australian market, recovering subsequently to a trading range of about USD 0.7000. To the extent that the effective rate fell much less sharply than the bilateral US dollar rate, the Australian dollar suffered a backlash from the world-wide strength of the US dollar, and in this respect Australia's experience was not much different from that of most other countries.

But there is also a deep-seated domestic factor underlying the developments in early 1985, one which in retrospect may have masked Australia's relatively tranquil transition to floating. The float was inaugurated at a time when the Hawke Labor Government had successfully negotiated an industrial truce in Australia with its 'consensus' approach to economic management. In the early weeks of 1985, however, it would have appeared to many observers and market operators that the government's industrial 'accord' was running out of steam. Combined with continuing weak terms of trade, bad January trade figures, and softening domestic interest rates (due, ironically, to an industrial dispute which slowed down the government's collection of taxes), this configuration of events was enough to set off the precipitous decline of the Australian dollar in the exchange market.

In terms of the floating versus crawling debate, however, the issue is not merely one of isolating the factors which may have contributed to any given exchange-rate outcome, but also the question of what is likely to have happened had the Australian authorities persisted with their regulatory approach to exchange-rate management. With the set of conditions prevailing at the beginning of 1985, it is virtually certain that pressures on the spot rate would have developed. Had the authorities continued with their 'very gentle, sometimes almost imperceptible, adjustments' in the exchange rate, the pressures would have quickly spilled over into the domestic money market, much along the lines of the 1983 devaluation crisis. The government would then have been faced with one of two unpleasant alternatives: either to adjust the exchange rate by a more or less arbitrary amount, in which case the exchange-rate outcome might not have been very different; or to risk extremely disturbed conditions in the domestic financial markets which had every potential of blowing out into financial panic. It may be some comfort to Australia's policy makers that under floating regime the latter never eventuated.

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