Financial Deregulation and Monetary Policy in Australia *

Introduction

Since publication of the Campbell (1981)[1] and Martin (1984)[2] Reports the pace of financial deregulation in Australia has accelerated markedly. Less reliance on direct controls, a floating currency and a less regulated banking system will all serve to transform the Australian financial system, but what will this imply for policymakers? This article addresses the question from a monetary policy viewpoint and establishes some of the difficulties that policymakers are likely to face as the system evolves. As indicated below, perhaps the most crucial test facing the authorities is the need to strike an 'appropriate' balance between preserving the stability of the payments system and ensuring competitive equity between financial intermediaries, bank and non-bank.

Financial Deregulation since Campbell

Surprisingly for most commentators, it has been left to a Labor Goverment to implement most of the fundamental changes called for by the Campbell Committee and largely endorsed, following due consideration of the government's social and economic aims, by the Martin

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[1] "Australian Financial System: Final Report of the Committee of Inquiry", AUSTRALIAN GOVERNMENT PUBLISHING SERVICE (Canberra, 1981).

[2] "Australian Financial System: Report of the Review Group", AUSTRALIAN GOVERNMENT PUBLISHING SERVICE (Canberra, 1984).

Group. As Table 1 indicates, this involved the floating of the Australian dollar, less reliance on exchange control, the abolition of maturity controls on banks, the relaxation of controls on savings banks, the abolition of the '30/20' rule[3] and an invitation to interested parties to apply for new banking licences. Together with the earlier deregulation of interest rates (bar those on loans of under $100,000 made in the form of overdrafts or farm development loans or for the purposes of owner-occupied housing) and termination of quantitative lending controls on trading banks, the moves place Australia firmly in line with other countries, such as the UK and US, which have taken the monetary deregulation trail. But where will this lead and what problems are likely to emerge for policymakers?

Implications for Monetary Control

One of the first issues to examine is the likely *structural adjustment* that deregulation will induce (Hall, 1985). In the light of the plethora of controls previously endured by the trading banks, a reflux of business to them can be expected, both from their subsidiaries (deliberately set up to evade controls) and other financial intermediaries. 'Pure' reintermediation may also result. In so far as the trading banks experience growth in short-term (i.e. less than 14 days) deposits, this is likely to be at the expense of the merchant banks[4] and cash management trusts. Savings banks too can be expected to benefit from the loosening of their regulatory straitjacket. Finally, credit unions, finance companies and building societies (especially if state deregulation lags behind federal deregulation and restrictions on inter-state activities remain) are likely to suffer from an intensification in competition on both sides of the balance sheet.

A second general issue surrounding deregulation relates to the likely impact on the average levels and volatility of *interest rates and*

[3] A requirement made of life insurance companies and pension funds (introduced in 1961) to hold at least 30% of their assets (or increase in assets above a base) in the form of public securities, of which at least 20% must be in Commonwealth securities, as a *quid pro quo* for favourable tax treatment (see Campbell Report, Paras. 10.5-10.50).

[4] Which previously had a virtual monopoly on the taking of very short-term deposits.

TABLE 1

POST-CAMPBELL FINANCIAL DEREGULATION

Date of Announcement	Deregulatory Move
March 1982	The minimum period for which *trading banks* may offer fixed deposits and CDs was reduced from 30 days to 14 days for amounts of $ 50,000 and over and from three months to thirty days for fixed deposits of under $ 50,000.
March 1982	*Savings banks* were authorised to offer fixed deposits of less than $ 50,000 for terms of 30 days to 4 years.
June 1982	Effective 1 July, *authorised money market dealers* were allowed more flexibility (i.e. could hold up to 30% rather than 20% of gearing limits) in the composition of the non-Commonwealth Government component of their portfolios.
June 1982	The *Loan Council* decided that: (i) a tender system would replace the tap system for selling Commonwealth Treasury bonds; (ii) the power to determine the terms and conditions of Australian Savings Bond issues would be delegated to the Treasurer; (iii) major electricity authorities would be freed, in respect of their domestic borrowing, from Loan Council controls.
June 1982	With effect from the end of June, *quantitive controls* on trading bank lending were discontinued.
August 1982	Effective 31 August, the 40% 'prescribed assets ratio' imposed on *savings banks* was replaced with a 15% 'liquidity ratio'. In addition, savings banks were allowed to invest up to 6% of deposits in assets (other than fixed assets) of their choice, and restrictions on sources of deposits were relaxed to allow deposits to be taken from trading or profit-making bodies up to a maximum, for each entity, of $ 100,000.
July 1983	*Loan Council* controls over the domestic borrowing of larger local authorities were discontinued.
December 1983	Effective 12 December, the Australian dollar is to be allowed to *float* freely and exchange control to be largely dismantled.
April 1984	Effective 1 August, all *maturity controls* on trading and savings banks are to be removed. This will allow banks to take deposits for less than 14 days and over 4 years to maturity.
April 1984	Effective 1 August, *banks* are to be permitted to offer interest on chequing accounts and call money.
April 1984	Effective 1 August, *savings banks* will: (i) be able to offer chequing facilities on all accounts; (ii) no longer be subjected to the $ 100,000 limit on deposits held by a trading or profit-making body; (iii) be able to take fixed deposits of over $ 50,000.
September 1984	The '30/20' rule imposed on life insurance companies and pension funds was abolished.
September 1984	Criteria for (foreign) bank entry were clarified and applications for new banking licences were invited.
February 1985	The names of the 16 foreign concerns to receive banking licences were announced.

exchange rates. Whilst there is little agreement on the costs associated with volatility (e.g. some still believe that exchange rate volatility damages trade although the weight of empirical evidence suggests otherwise) there is a general consensus that more volatility will result. As Bilson (1982) notes, the floating of the Australian dollar and dismantling of exchange control will enhance the interdependence between Australia and other countries causing, in all likelihood, greater volatility in both rates. Australian interest rates will become linked to world interest rates through the interest rate parity condition (resulting from covered arbitrage), although a flexible exchange rate will help to insulate domestic interest rates by allowing fluctuations in forward discounts/premia. With respect to exchange rate volatility, the present phenomenon of 'overshooting' is likely to continue, in line with predictions of the asset market approach to exchange rate determination, which asserts that exchange rate changes are *not* closely associated with movements in differential inflation rates in the short-run as prices adjust to economic conditions more gradually than asset prices (for the collapse of the purchasing power parity condition *see* Frenkel, 1981).

In practice, the authorities may have to choose between greater variability in the exchange rate and greater interest rate volatility stemming from international instability. An obvious example relates to the impact of US policies, where a monetary tightening in the US would force the Australian authorities either to accept the inflationary implications of a depreciating exchange rate or the deflationary implications of raising domestic interest rates to hold the exchange rate. The authorities' tactics will, of course, depend upon their subjective estimate of the optimal, short-run inflation/unemployment trade-off, but it could be argued that foreign exchange operators are better equipped to deal with volatility (through the forward and hedge markets) than the generality of investors (Valentine, 1983).

On the question of the impact of deregulation on interest rates, both the abolition of ceilings on loan rates and the ending of the prohibition of payment of interest on short-term deposits have to be considered. Ceilings abolition, in so far as ceilings were made low enough to 'bite', will obviously tend to raise both the average level of loan rates and their volatility. The effect of deregulating deposit rates is more subtle, however. As Davis and Lewis (1983) point out, in a competitive world with flexible deposit rates, the achievement of a particular change in *relative* yields (say between Government security yields and bank deposit rates) necessary to induce the desired degree

of monetary restraint will require a larger change in *absolute* yields than was necessary when deposit rates were controlled. This is because, within a deregulated, competitive financial system, the higher market yields will be passed on to depositors so that the 'own' rate on money will rise, thereby narrowing the interest differential created by a given change in Government security yields.[5] Hence deregulation is likely to make interest rates in Australia both more volatile[6] and higher on average relative to the recent past.

Reintermediation, financial innovation, the abolition of exchange control and less interest-sensitive demand for money functions, both wholesale and retail, as current accounts increasingly come to offer market-related interest rates and payment facilities, will all pose problems for *monetary targeting*, at least during transitional periods.[7] For, while it is true that the relationships between different monetary aggregates will become more stable once the transition to a deregulated environment has been made, in the intervening period interpretation of movements in the targeted aggregate (M3)[8] will become more problematic. Whilst this may be downplayed by the authorities, who have, for a number of years, indicated that policy judgments are not made on the basis of movements in a single indicator, others, and especially the money and foreign exchange market operators, may continue to judge policy in accordance with its record in achieving the monetary 'projections'.

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[5] The reduced interest rate sensitivity of the demand for money implies that, within the general equilibrium IS/LM paradigm: (i) a given change in the money supply will lead to a larger change in real income and interest rates (i.e. interest rates and nominal income are likely to become more sensitive to disturbances in financial markets); (ii) the effects on economic activity of disturbances in the real sector of the economy (e.g. due to discretionary changes in fiscal policy), for a given money stock, will be reduced.

[6] As the BANK OF ENGLAND has pointed out (1983, p. 362), financial innovation may also make interest rates more volatile because it tends to render monetary aggregates less interest-sensitive. The problem has already appeared in the UK and arises because a large part of credit provision occurs on a floating rate basis (e.g. overdrafts, mortgage loans) with the result that increases in interest rates may have a smaller impact on the demand for credit because the incentive to wait for lower rates is reduced (as the borrower is not locking himself in to fixed rates).

[7] Benefits, however, result form the floating of the Australian dollar which, making due allowance for short-term "smoothing" and limited official intervention to "test" the market, effectively insulates the domestic money stock from capital flows. This removes a major impediment to the successful conduct of monetary policy since, under the old 'flexible peg' arrangements, banks short of cash reserves could always obtain them by bidding funds from abroad, occasioning reserve creation on the intervention of the Reserve Bank to stop/slow the appreciation of the Australian dollar. By changing the environment in which liability management takes place the authorities may, however, create transitional problems in the interpretation of financial data as the correlation between M3 and bank advances may be weakened and the cyclical behaviour of M3 modified.

[8] M3 is defined as currency in circulation plus total deposits, including CDs, with all trading banks and savings bank.

Leaving aside the general, yet crucial, issue of whether or not monetary aggregates are demand-determined (Valentine 1984; Davis and Lewis, *op. cit.*), a number of practical difficulties will therefore have to be dealt with in the short to medium term. Reintermediation will cause a surge in M3, both in absolute terms and relative to broader aggregates, the problem being to predict the magnitude and timing of the shift of business back to banks (and especially savings banks). Similarly, financial innovation, although apparently causing few problems to date in the unsettling of demand for money relationships (Thurloe and Valentine, 1984), is likely to complicate interpretation of movements in transactions-based aggregates (e.g. M1,[9] as NBFIs increasingly offer more payments facilities with their 'deposit' accounts, banks extend their range of interest-bearing chequing accounts and developments in electronic funds transfer reduce the demand for cash and chequing facilities. By allowing residents to hold foreign currencies and non-'official' overseas holdings of Australian dollar deposits without limit, the dismantling of exchange control will further complicate matters.

Less interest sensitive demand for money functions will adversely affect economic management by forcing the authorities to accept a higher level of interest rates in order to achieve a given degree of monetary restraint. (A similar result would hold if the wider development of the inter-bank market in Australia allowed more effective bank liability management.) In the past, *direct* controls in the shape of quantitative lending guidelines, interest rate controls, restrictions on the source and term of deposits and asset ratio controls were employed to limit the need for and political damage caused by interest rate increases, in much the same way as lending ceilings and the *'corset'* (Hall, 1983, Ch. 4) were used in the UK. And, today, even allowing for deregulation, trading banks subject to the 1959 Banking Act still suffer the Statutory Reserve Deposit (SRD) instrument, the Liquid Assets and Government Securities (LGS) convention, qualitative lending guidelines and interest rate ceilings on certain loans under $100,000. Savings banks' activities are, likewise, still severely circumscribed despite substantial deregulation. They are subject to the same lending guidelines and interest rate ceilings and, in addition, to a minimum 15% liquidity ratio (the ratio of cash, deposits with the Reserve Bank and short-term Commonwealth

[9] M1 is defined as currency in circulation plus current accounts with all trading banks.

government securities to deposits), to a limit ($4m. plus 2.5% of Australian dollar deposits) on the amount of funds that can be held with trading banks, and to a requirement to keep at least 94% of their Australian deposits in prescribed asset form, i.e. in cash, deposits with the Reserve Bank, deposits with and loans to other banks, public sector securities, secured loans to authorised money market dealers and housing loans.

The Campbell Committee (Ch. 4) came out strongly against the use of direct controls for monetary policy purposes. They were criticised as being: (i) distortive (disintermediation through the inter-company market and, with respect to mortgage lending, through solicitors, occurred; banks switched business to their unregulated subsidiary finance houses and merchant banks; and 'hard arbitrage' opportunities were created for those able to draw-down overdrafts to redeposit in the short-term markets); (ii) ineffective (the overdraft system could be used to avoid or delay the impact of restrictive measures and credit could still be obtained from the unregulated sector); (iii) responsible for a misallocation of resources (e.g. interest rate controls induce dramatic growth in 'wasteful' non-price competition in the shape of unnecessarily-large branch networks and advertising); and (iv) responsible for a loss of *allocative* (savings are prevented from gravitating towards outlets offering the highest, risk-adjusted, rates of return) and *dynamic* (the operational flexibility of institutions subject to the controls is impaired) efficiency. Moreover, to the extent that such controls (e.g. savings banks' prescribed asset ratios and lending ceilings [10] in connection with the provision of housing finance) are used to provide sectoral assistance or to secure social objectives, it would be preferable if the fiscal system were used to provide explicit subsidies. The Martin Group agreed with most of these points except that it did not rule out, because of the importance of the government's social objectives, the use of prescribed assets ratios on savings banks nor, as a second-best solution, interest rate ceilings on housing loans.[11]

Given the strength of the case against the use of direct monetary controls it is worthwhile considering the likely future of the SRD/LGS

[10] As an instrument of social policy, lending ceilings are unlikely to achieve their objective of diverting low-cost finance to low-income borrowers. This is because the supply of housing funds available will dry up once market rates move above regulated rates, and non-price rationing techniques will tend to favour those borrowers on higher incomes.

[11] The Group did, however, recommend that the "free tranche" of assets available for investment at the savings banks' discretion be increased from 6% to 10% and that all interest rate controls on trading and savings banks be abolished.

mechanism and the justification for retaining *any* form of direct control. The purpose of the SRD instrument, whereby trading banks are required to hold a set proportion of their Australian deposits in an SRD account at the Reserve Bank (which currently earns a below-market rate of interest of 5% p.a.), is to allow the Reserve Bank, through changes in the ratio, to exert influence on interest rates. The interest rate changes that actually take place will depend upon the nature of the banks' response to the cash reserve pressure, which can take the form of bidding more strongly for cash reserves and deposits,[12] reducing holdings of assets (subject to maintaining LGS assets at a minimum of 18% of deposits),[13] or a combination of both. To the extent that banks react by slowing down deposit growth (or reducing deposits in absolute terms) which, to a large degree, will be done through interest-rate rationing of advances, growth in M3 will be slowed. Whatever the pattern of response chosen by the banks, the upward pressure on interest rates resulting from asset sales or liability management is transmitted to financial markets more generally through the reactions of banks' customers and competitors in the process of restoring equilibrium in financial markets.

The case for retaining the SRD instrument or similar variable reserve ratio[14] is based upon the following two arguments. Firstly, that it may be necessary, on occasions, to supplement open market operations in Commonwealth bonds or Treasury notes with some form of direct control. This argument hinges largely upon a belief in the

[12] Remembering that, until very recently, the ability of banks to manage their liabilities was severely circumscribed by various interest rate and maturity controls on deposits and by the lack of a well-developed interbank market.

[13] As a result of the recent moves adopted towards increasing the flexibility of Commonwealth government security yields it is not clear that the LGS convention has anything left to offer on the monetary policy front. This is because banks no longer have a financial incentive to run down government security holdings first in response to a reserve squeeze nor can they expect to secure more reserves through a reduction in their net take-up of such securities.

[14] If a variable reserve ratio is to be used as a monetary control device two further questions have to be answered: (a) should the requirement be mandatory or voluntary?; (b) should market rates of interest be paid on required reserves? In coming to a conclusion on the first issue, the disintermediation incentives provided by any form of mandatory reserve requirement that differs from that desired by banks will have to be weighed against the uncertainties associated with allowing banks to determine their own reserve positions. (In the UK, the authorities successfully use the clearing banks' balances *voluntarily* held at the Bank of England for clearing purposes as the fulcrum for official money market operations designed to influence short-term interest rates.) With regard to the payment of market rates on (required) reserves, the difficulties of forecasting the reintermediation effects due to the removal of an effective tax on bank intermediation (DAVIS and LEWIS, *op. cit.*, p. 92) have to be balanced against the efficiency gains resulting from removal of distortions to the financial system (although NBFIs claim that, as access to the payments system is effectively denied them, it would further accelerate their demise – *see* pp. 272-273).

segmentation of financial markets which might account for differing interest rate responses (and associated real effects) to open market operations and reserve ratio changes (Davis, 1981). Alternatively, it may be believed that additional benefits may arise from the "announcement effects" that accompany changes in the SRD ratio. And secondly, it might prove necessary at some point in the future to ensure that banks maintain *some* holdings of cash reserves to serve as a fulcrum either for a cash-based system of money supply control (such as *monetary base control*) or for a system reliant upon interest rate control of the demand for money and bank credit effected through open market operations. The need might arise as, in a completely deregulated world, the demand for cash might fall to zero if small transactions are accommodated by transactions in tradeable bank paper and EFT/POS (Electronic Funds Transfer at Point of Sale) systems account for the electronic execution of the rest (Harper, 1984). Finally, it is possible to argue for the retention of some form of direct control on the grounds that it might have a speedier and more predictable impact on the targeted aggregate, considerable virtues when annual targets are specified and policy judged accordingly by the markets and where inflation expectations are encouraged to rest so heavily on the achievement of the target!

Implications for the Prudential Regulation of Deposit-Taking Financial Intermediaries (DTIs)

The existing panoply of prudential controls covers market entry, capital and liquidity adequacy, restrictions on business activities, loan concentration, country risk, foreign currency exposure and liquidity/solvency support arrangements. The Reserve Bank has no statutory powers to determine such requirements (other than investment policy for savings banks) but some direct controls, such as the LGS mechanism and savings banks' asset ratios may perform prudential functions. The Banking Act, however, does impose upon the Reserve Bank a duty to protect *banks'* depositors and empowers it to investigate the affairs of a bank which has declared that suspension of payment is imminent or that it is unable to meet obligations[15] and to take over control until

[15] Or, alternatively, following concerns raised in reports from the Auditor-General.

repayment of depositors is assured. To date (the entry of foreign banks may necessitate the embodiment of formal prudential powers within the Banking Act), the Reserve bank's supervisory role has centred on detailed discussions with banks' management, scrutiny of internal control procedures and analysis of financial data as the means of ensuring that appropriate prudential standards are adopted.

Although the Financial Corporations Act does not require the Reserve Bank to perform a depositor protection function with respect to subject corporations, the Reserve Bank, nevertheless, is obliged to preserve the stability of the financial system as a whole. To that end, the Reserve Bank is willing to provide liquidity support facilities, where necessary, to

> "individual banks which stand behind the liquidity needs of those individual financial institutions which are responsibly managed and have adequate asset backing" (RBA, 1983, p. 30).

Moreover, the Reserve Bank keeps a careful eye on the activities of the major NBFI groups through the collection and analysis of data, as required by the Financial Corporations Act, and through direct consultations. Because of the importance of their market-making functions, the authorised dealers in the short-term money market receive special attention, and agreements have been reached with respect to gearing ratios and portfolio composition. Finally, the relevant State or Territory legislation determines the prudential arrangements applicable to permanent building societies and credit unions, the major deposit-taking NBFIs.

To gain an insight into the likely future evolution of prudential regulation of DTIs it is useful to analyse what the Campbell and Martin Reports had to say on the subject. For the purpose of this paper, the general approaches proposed will be outlined together with a more detailed discussion of the recommendations made in respect of access to the payments system and bank entry controls. [Space considerations preclude discussion of other aspects of prudential regulation but *see* Hogan and Sharpe (1983) for an illuminating critique.]

The *Campbell Committee* argued that a functional approach, making due allowances for differences in risk attaching to different business operations, to regulation would best serve considerations of 'competitive neutrality' and efficiency and duly proposed that financial intermediaries soliciting funds from the public should, for the purposes of prudential regulation, fall under five categories: banks, authorised dealers, non-bank DTIs which solicit small deposits from households

without issuing prospectuses, institutions which solicit small investments from households through the issue of prospectuses, and other institutions which only accept large deposits, predominantly from the business sector (Report, Para. 19.17). In respect of banks, the proposed schema of controls embraced capital and liquidity adequacy, liquidity support (at the Reserve Bank's discretion and subject to conditions) and risk asset limits (on loans to 'controlling' shareholders and directors and on 'large' loans and possibly on foreign currency exposure, spot and forward, in individual currencies and in aggregate). Interest rate controls and restrictions on business activities, on either side of the balance sheet, were eschewed.[16] Banks would continue to be regulated under the Banking Act which should "provide for the capacity to impose prudential requirements by regulation, but in the expectation that formal regulation would not generally be used" (Report, Para. 19.158). In the case of non-bank DTIs, the underlying principles of prudential regulation[17] were held to be the same suggesting that comparable, but perhaps less vigorous, treatment to that given to banks was necessary. Supervisions was to remain a State responsibility but a rationalisation and standardisation of State controls was called for.

The *Martin Group* agreed with many of the sentiments embodied within the Campbell submission and with most of the proposals suggested. For instance, it argued that banks should be placed in a special category for prudential supervision, that formal prudential powers should be incorporated within the Banking Act (but with the expectation that moral suasion would suffice so that the powers would not generally need to be invoked), that prudential requirements, incorporating capital and liquidity controls and liquidity support facilities, should be tailored to the particular risk characteristics of individual institutions' balance sheets and that regulation of non-bank DTIs should remain a State responsibility. The Group, however, opposed the consolidation principle espoused by the Cambell Commit-

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[16] Although the Committee believed that the privileges granted to the authorised dealers by the Reserve Bank justified continued regulation of their asset composition.

[17] The following guiding principles were to apply: financial institutions should be allowed to fail; a liquidity 'safety valve' should be available to intermediaries; investors should receive reasonable protection against fraud and malpractice; there should be a 'fair', well-informed market in securities — disclosure of relevant information should be ensured by the Government; entry requirements should be concerned only with depositor protection; prudential requirements should be applied in a flexible manner, leaving intermediaries with maximum freedom to adjust to changing circumstances, and should aim at ensuring *competitive neutrality* amongst intermediaries; regulation should not impair the provision of a reasonably full spectrum of risk/return investment opportunities.

tee, demanded the imposition of tougher restrictions on bank entry, and supported the retention (subject to some greater flexibility) of asset controls on savings banks.

Criticisms of the Campbell proposals, and by implication, given their similarity, the Martin Group's proposals also, are numerous. For example it can be argued that the Committee's proposals are inconsistent with a general thrust towards a deregulated and more efficient financial system. As Hogan and Sharpe see it, the

> "lack of a basic understanding of the nature of risk in financial intermediation, of the effects and functions of regulations, and of the interdependencies between economic variables has led the Committee to propose a panoply of overlapping and unnecessary controls of dubious effectiveness for investor-depositor protection. Furthermore, in terms of other policy objectives, the Committee's prudential controls will have a deleterious impact on monetary control, segment financial markets so reducing market efficiency and the effectiveness of open market operations, encourage disintermediation, and reduce the spectrum of risk-return investment opportunities available to investors." *(op. cit.* 1983, p. 160)

A possible justification for the recommendation of a formal system of prudential controls is that the Committee hoped, in the process, to make some of its other proposals more workable and acceptable.[18] For instance, some of the foreign banks admitted under new entry proposals might be smaller and less experienced than the domestic trading banks, requiring strict surveillance. Moreover, most would want to 'play' the game of banking strictly by the rule book, allowing less room for moral suasion.[19] A second general criticism relates to the fact that the role of deposit insurance and other non-regulatory approaches to depositor protection was overlooked (Hogan and Sharpe, *ibid.*; Perkins, 1982; Wood, 1982). And, thirdly, the proposals were taken to task for allowing too much discretion to policymakers (for example in the granting of banking licences, activating support facilities or in specifying capital ratios), thereby creating uncertainty.

On the question of participation in the domestic cheque *payments system,* the two Reports were unequivocal: only banks should be able to have their cheques cleared through the clearing system (Campbell

[18] As PERKINS (1982) has pointed out, detailed controls may be unavoidable if, in practice, the authorities are reluctant to let even weak banks fail, for without such controls banks are encouraged to act recklessly.

[19] This mode of implementing and enforcing the controls has also been criticised as an inconsistency, given the Committee's strong dislike of the use of moral suasion on the monetary policy front.

Report, Para. 23.54; Martin Report, Ch. 7, Para, 2.31).[20] The reasons given were the same in both cases — confidence in the payments system must be above suspicion so that only those subject to 'banking' prudential standards are eligible for consideration. The recommendations were made in spite of an acknowledgement that the principle of 'competitive neutrality' would be breached:

> "the provision of payments system facilities — both domestic and international — makes it easier for an institution to also provide related financial facilities; this is particularly so at the retail end of financial markets where the convenience and time saving involved in 'one stop' banking offer powerful attractions. The right to provide payments system facilities thus has significant implications for competitive balance across a wide spectrum of financial intermediation." (Campbell Report, Para. 23.45)

A carrot, in the shape of access to electronic funds transfer, was however offered to non-bank DTIs in the belief that developments on this front would erode the advantages pertaining to membership of existing payments systems.[21] As far as new banks are concerned, both Reports advocated that the Reserve Bank oversee negotiations for membership of the cheque clearing houses or for the provison of agency facilities for non-clearing banks by clearing banks, in the latter case to ensure their availability on reasonable but commercial terms.

The decision to support continued denial of direct access to the cheque clearing system to non-bank DTIs may be challenged on two grounds. Firstly, given the willingness of both bodies to contemplate wide-ranging reform of prudential regulation, it is not clear why the standards of prudence demanded of non-bank DTIs could not be made comparable with those demanded of banks. In this context, the role of deposit insurance might have received greater attention for it is apparently this form of depositor protection which enables the authorities in Canada and the United States to allow non-bank participation in the clearing system. And secondly, although NBFI groups in the past have generally not sought direct access but instead have campaigned for arrangements which facilitate indirect participation,[22] the likely future

[20] The Campbell Committee went even further and recommended that only banks be granted the authority to issue cheques.

[21] Though no figures were offered as estimates of the extent to which cheque-based transactions would be displaced by transactions undertaken through electronic transfer systems.

[22] Indirect participation by the issue of third-party cheques has generally not been resisted by banks but agency arrangements (*see* Martin Report, pp. 182-83) have, on the grounds that banks would lose their competitive advantage of being able to offer superior cheque account facilities. Frequently this resistance takes the form of bank demands for unrealistically-high fees.

intensification in competition for retail financial services following financial deregulation and innovation and advances in payments technology may necessitate direct participation by NBFIs in the payments system if they are to survive in the long-run (Corrigan, 1982). If this is not forthcoming there may be a need for 'secondary' regulations (Davis, 1984) to limit the ability of banks to diversify.[23]

Finally, on the subject of *bank entry controls,* there is widespread unease at the prospect of a continuing lack of *effective* competition in the banking industry. Following the mergers of 1981,[24] the number of major trading banks was reduced to four, although the Australian Bank became the first new bank to open since 1945 in the same year. Latterly, the apparent cause for the dearth of applications for banking licences from domestic bodies was the perception that, despite the privileges associated with access to cheque clearing, foreign exchange licences and official lender of last resort facilities, monetary regulations placed banks at a competitive disadvantage vis-à-vis NBFIs. Monetary deregulation has, of course, now transformed the situation to a position where there is a strong incentive to possess a licence because of the associated prudential privileges just mentioned. The problem for potential entrants is, however, that a limit will be placed on the number of licences issued for reasons other than those associated with a desire to ensure the adequacy of capital and other prudential standards. This will mean that 'supernormal'[25] profits will continue to be earnt by those enjoying oligopolistic competition.[26]

The Labor party's decision (endorsed in July 1984) to admit foreign banks,[27] despite earlier hostility from within its own ranks, will go some way to reducing these efficiency losses by increasing competition and

[23] By limiting the number of new-banking licences (*see* p. 275) the authorities are effectively ruling out the option of conserving competitive equity through the provision of perfect freedom of entry to "banking".

[24] Westpac Banking Corporation was formed from a merger between the Bank of New South Wales and the Commercial Bank of Australia, and the National Commercial Banking Corporation of Australia resulted from a merger between the Commercial Banking Company of Sydney and the National Bank of Australasia.

[25] I.e. profit greater than that necessary to persuade the banks to remain in the industry (or product area).

[26] Similarly, past experience suggests that exit from the industry will be far from "free", a problem which might have been overcome if deposit insurance had been introduced (WOOD, *op. cit.*).

[27] At the end of 1983, only two foreign banks, the Banque Nationale de Paris and the Bank of New Zealand, had full banking licences, although many more had close ties with Australia through equity interests (up to 100%) in merchant banking and finance and investment companies, and through the establishment of Representative Offices.

innovation in banking. This should lead both to an improvement in services and a reduction in margins, to the benefit of the community. Moreover, through a broadening of the capital market, Australia's role as a regional financial centre should be enhanced. Strings, however, are attached to the granting of a licence. The more 'legitimate' relate to prudential concerns, where a general requirement to operate within the framework of prudential concerns established by the Reserve Bank[28] will be written into new banking authorities. More specifically, a minimum paid-up capital of $25m., local incorporation, and detailed analysis of proposed business plans and managerial control systems were required. Additionally, applicants[29] had to indicate the extent of the financial responsibility they would accept with regard to any proposed banking entity in Australia. The more contentious requirements related to desires to seek a geographical spread (preference to be given to those banks which facilitate the development of Australian industry and have previous and current relations with Australia), taking due account of the principle of reciprocity, and to ensure a high degree of local equity participation. The last requirement flies in the face of the Campbell recommendation that "banking licences issued to non-residents should not be subject to mandatory resident equity participation requirements" (Para. 25.59) but dilutes the demands of both the Martin Group and the Labor party as the preferred local equity level was established at 50%. The authorities, however, reserve the right to grant outright control or even complete ownership where the benefits are deemed to warrant it.

Having accepted the inevitability of foreign bank entry (and the concomitant competition, especially for the business of foreign companies), since the publication of the Campbell Report,[30] the domestic banks, nevertheless, hold reservations on the following fronts: (i) new entrants may gain market share through loss-leading activities or because of their high gearing (e.g. Japanese banks); (ii) domestic banks may be at a competitive disadvantage because foreign banks are likely to be less susceptible to Reserve Bank moral suasion (e.g. on "controlled"

[28] Covering capital and liquidity adequacy (in the formative years the requirements may be more severe than for banks already established), managerial competency, adequacy of managerial control and monitoring systems for limiting risk exposure, and equity links with non-banks and other banks.

[29] In the event, 42 separate applications were made for the 16 licences eventually granted (in February 1985).

[30] Indeed, the 1981 mergers (*see* note 23) were, fundamentally, a defensive action (STEARN and TRESS, 1984) against such a possibility.

lending); (iii) foreign banks are likely to gain a competitive advantage through not having to operate a substantial branch network; and (iv) reciprocity on the same terms is unlikely to be offered to Australian banks (in the event, the principle was accepted by overseas authorities, including the Japanese). One can sympathise to a degree with the reservations expressed in points (i) and (ii), but domestic banks must be encouraged to deal with the problem of cost-ineffective branch networks and lack of a reciprocity agreement has not stopped Australian banks from increasing their activities overseas in recent years (e.g. in the US and the Far East).

Summary and Conclusions

Monetary deregulation and prudential "reregulation" are current features of development in many highly developed financial systems, including the United Kingdom and the United States. Hence the experience of Australia is likely to hold significant implications for the monetary authorities in these and other countries contemplating similar regulatory moves (e.g. Japan). As indicated, deregulation in Australia will, in all likelihood, lead to greater exchange rate and interest rate volatility, causing the average level of interest rates to rise in the process. Monetary management, especially while it is conducted through a framework of targeted monetary aggregate growth, will be complicated by ensuing structural adjustment and financial innovation, and the authorities would be wise to retain some form of direct control for possible use in the future. The operational difficulties facing the authorities are just as acute on the prudential front, where considerations of competitive equity and efficiency have to be balanced against depositor protection and stability concerns. It remains to be seen if an 'appropriate' balance can be struck.

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