The Australian Financial System - Directions for Reform*

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* Based on a talk presented to the Canberra Economics Society, 10/9/80.

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> "The study of money, above all other fields in economics, is the one in which complexity is used to disguise truth or to evade truth, not to reveal it".
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> J.K. Galbraith, Money (Penguin 1975), pp. 14-15.

> "... the committee's increasing fascination with the complexities of the financial system and the regulatory structure in which it is enmeshed seem to be leading it from the belief that the most important consideration is the service provided to the public towards the belief that the most important consideration is the stability of the system".
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> P.P. McGuinness, 'How the system protects itself', National Times, August 31, 1980.

Economists are rarely accused of worrying unduly over institutional complexities; normally they face the opposite change of over-simplification. Which is the worse crime is unclear. Undue concern with complexities can obscure "truth" and lead to wrong conclusions - but so can simplification. At this stage, however, the Campbell committee can hardly be accused of either crime. Their comprehensive interim report simply describes the current situation, summarizes competing arguments, and refrains from making judgements on any of the important issues.

Consequently, it is difficult (if not impossible) to predict the direction of suggested reform. However, if the weight of numbers (and force of repitition) plays a role in shaping the committee's thinking, final recommendations for a less regulated system seem imminent. "Most submissions ... view present levels of government intervention as

excessive ..., they argue that a free and competitive system tends to promote both allocational and operational efficiency, and that government regulation distorts the workings of the competitive process". (para 23.1)

Such arguments deserve, and no doubt will get, close scrutiny - for their appeal lies partly in their simplicity. The call to move closer to a land of milk and honey loses its appeal if an impassible swamp surrounds it. Probably, we are already in the quagmire; the committee needs a torch to help us find the best available solid ground - not a beacon on top of some distant unattainable hill.

As these comments no doubt indicate, I have some doubts that deregulation will be automatically accompanied by net benefits. The financial system is complex, and while increased competition can be beneficial, those benefits depend crucially upon the nature of the resulting competition.

1. The Committee's Modus Operandi

The mammoth task confronting the committee of making recommendations on; the structure of the financial system; regulation and control of the system; and relevant legislation, raise something of a "chicken and the egg" problem. While it would seem desirable to ascertain the appropriate institutional structure and, where necessary because of market failure, to append the required regulatory structure, institutions are (at least in part) a product of the regulatory and legislative framework. What comes first, a structure or (some) regulations?

This question raises issues which have received only minor attention in the interim report. For, by starting with the existing institutional

and regulatory structure, the natural tendency is to "tinker" rather than examine fundamental changes. While the report is strong on questions relating to the current segmentation of the financial sector into intermediary "types", there is little discussion of whether these "types" are, in any sense, appropriate. For example, why should short term funds obtained from the household sector be primarily directed towards providing long term finance for that sector? New "types" of intermediaries currently inhibited or prevented by legislative and regulatory requirements may be desirable.

Unfortunately, while economic theory can explain why intermediaries, in general, exist, it has little to say about the determinants of intermediary "types". Probably, I suspect, this is because institutional forms have been largely influenced by legislation. Nevertheless, the questions are vital, since the institutional structure is important in trasmitting the effects of changing preferences and random shocks throughout the system. While many submissions, referred to in the report, point to "gaps" in financial markets, little attention seems to be given to changing the pattern of market segmentation - except in marginal ways.

Similarly, concentration on the status quo has led to a lack of questioning of the suitability of existing financial instruments, with the exception of possible innovations in the form and range of government paper. For example, while the tendency for trading bank lending to shift from overdraft to fixed term, fully drawn arrangements is noted, I can find no arguments in the report relating to the desirability or otherwise of this trend. Similarly, the suitability of financial instruments involving a fixed nominal repayment stream in periods of inflation does not appear to surface amongst the major issues.

At the centre of the committee's attention is the question of the appropriate roles for government and market forces in the operation of the financial system. The committee accepts that government involvement is not an end in itself but a means towards achieving certain ends, and places considerable emphasis on its intention not to judge "ends". Rather, it intends to focus upon the suitability of methods chosen to achieve these (often conflicting) ends. The criteria upon which judgement is to be based is the effects of such intervention on efficiency.

Given the committee's terms of reference such an approach is understandable, but it does involve dangers. Examining the effects of intervention to achieve macroeconomic policy, investor protection, concentration, and equity goals (those listed by the committee) solely on efficiency criteria neglects the interrelationship between the former goals. Undoubtedly the committee is aware of such problems; for example, that attempts to provide cheap housing finance via interest rate controls have effects on the attainment of macroeconomic policy goals, as well as efficiency. Perhaps pairwise comparisons between methods of achieving each goal and the efficiency consequences are the only practical approach, but it is difficult to see how sensible judgements can be made without considering <u>all</u> the relevant effects of government intervention.

2. Domestic Economic Policy - Some Issues

(a) The Long Run Ineffectiveness of Controls

Much of the opposition to the use of direct controls for the purposes of monetary policy stems from the view that they are self defeating in the long run. By imposing a "tax" (or cost) on particular

intermediaries, specifically the banking sector, direct controls are seen as encouraging the relative growth of other uncontrolled intermediaries - and so leading to a diminution in their effectiveness over time.

To the extent that direct controls distort financing patterns they involve undesirable allocative efficiency losses which must be balanced against any gains from greater macroeconomic stability. If the effectiveness of direct controls weakens over time, the justification for their existence is accordingly weakened.

However, unless the services provided by uncontrolled intermediaries are perfect substitutes for those provided by the controlled sector, there is no reason to expect a continual worsening of the latter's relative position. Rather, the imposition of controls will lead to a new equilibrium position in which the market share of the controlled sector is relatively lower. Even in a growing economy, there seems no a priori reason to expect the relative long run growth rates to be affected.

While it is difficult to assess the net effect of the costs and benefits to the Trading Banks of their close relationship with the regulators, and changes in the level of regulation, their share of total intermediary financing appears to have stabilized during the 1970s. Savings banks, on the other hand, have continued to experience a relative decline - despite an apparent reduction in the degree of regulation. Whether this reflects the existence of perfectly substitutable services from building societies etc., in which case the decline will persist as long as regulatory differences persist, or whether it reflects a transition phase to a new equilibrium is unclear - but is a vital question confronting the Inquiry.

(b) The Nature of Controls

One issue which has been raised before the committee is the question of whether a market rate of interest should be paid on required reserves. Such a step is seen by some as improving allocative efficiency, but by others - notably the authorities - as reducing the force of changes in the required reserve ratio.

This latter view may have merit if bank portfolio responses are highly unpredictable, in which case some penalty may be needed to ensure appropriate adjustments. However, it only considers a part of the overall adjustment of the monetary sector.

Payment of a below market rate of interest on required reserves will tend to lead, in a world of greater interest rate flexibility, to the yield differential between bank assets and liabilities varying directly with the required reserve ratio. Payment of a market rate will lead to this yield differential being invariant with respect the required reserve ratio. If the authorities control the money stock via control of base money and reserve ratios, but allow bank interest rate competition, the force of changes in required reserve ratio may be reduced when below market interest rates are paid. The reason for this result is that part of the monetary disequilibrium created will be absorbed in the money market, in response to changes in the yield differential, rather than flowing into other markets.

(c) The Operation of Policy

The committee argues that its consideration of particular policy instruments is influenced by the prior questions of whether, and if so which, intermediate targets should be adopted for the operation of

monetary policy. On this issue, I wish to make only one comment.

Advocacy of intermediate targets as a useful technique is premised on the existence of a reliable relationship between the intermediate target and ultimate policy objective(s). However, the relationship between intermediate targets and ultimate objectives may depend on the means chosen to influence the intermediate target. For example, changes in the money supply brought about by reserve requirement changes may have quite different effects on private sector interest rates and thus economic activity, than changes caused by open market operations. Consequently, it is unclear that choice of an intermediate target is logically prior to choice of policy instruments.

(d) Extending Controls?

While controls over financial intermediaries can impair allocative efficiency, such costs need to be evaluated against possible efficiency gains resulting from more fully employed resources, and resources freed from "hedging" against inflation, i.e., the possible benefits of greater macroeconomic stability. Currently, the impact of controls is unevenly distributed, raising two questions:

(1) Would a more even spread of controls improve macroeconomic policy performance?

(2) Would a more even spread of controls reduce allocative efficiency losses?

On the second of these questions, two points seem relevant. First, to the extent that efficiency losses increase more than proportionately with the "size" of controls, a spreading of controls may reduce the

overall loss. Second, by an extension of controls, control of monetary aggregates can be achieved by smaller changes in reserve ratios of all intermediaries than necessary if applied solely to the banking sector.

Given the purpose and costs of direct controls, their extension only makes sense if greater macroeconomic stability ensues. Uncontrolled intermediaries can, at least temporarily frustrate the intentions of monetary policy. Moreover, by delaying the impact of policy they may lead to policy being too severe in its application. The limited evidence I have seen suggests that the lag in response of uncontrolled intermediaries has partly frustrated policy, suggesting (to me at least) some grounds for imposing a variable cash reserve ratio upon non bank intermediaries.

3. Efficiency in Financial Markets

The premise, underlying many submissions to the committee, that a free and competitive financial system promotes efficiency, is one which I believe deserves careful scrutiny - given the inherent complexity of financial markets. Unlike the economic "goods" in textbook proofs of the optimality of competition, financial assets and markets are characterized by features which invalidate the proof. Consquently, the question to be asked is what "form" of competition is optimal, and what regulatory and legislative structure is necessary to achieve that. Let me attempt to demonstrate the issues by means of a few examples.

First, it is possible to demonstrate that competitive financial markets, with free entry, and under conditions of imperfect information which prevent complete assessment of risks, may be inherently unstable. Consequently a case for restricted entry into particular markets may have

some merit. Alternatively, some financial services such as provision of the payments mechanism, may have some elements of a "public good" nature about them, and be most efficiently provided by a restricted group of suppliers. Where such restrictions can be justified, some form of regulation to ensure that the appropriate form of competition occurs seems necessary, although I would note that the existence of a competing government financial institution which "leads" the market may reduce the grounds for regulation. Consider, as a specific example, the case of bank control over the payments mechanism. Banks impose an entry charge to the payments mechanism since individuals have to tie up resources in the form of greater than zero average current account balances to gain access. Unless banks allow universal instantaneous overdraft facilities, individuals have to forego resources which the banks can utilise to make profits. That could certainly be offset by the practice of banks making interest payments on current accounts, but efficiency losses are only fully offset if the interest is calculated on the average balance. I suspect that, as with the savings banks, interest would be paid on the minimum balance rather than the average balance, in the absence of regulation.

As a second example, we may note that placing funds with an intermediary is akin to granting power of attorney to the intermediary to invest those funds. Few individuals would grant power of attorney to anyone without some information about that person and their likely usage of the funds. Similarly, individuals who place funds with an intermediary will desire knowledge about the characteristics of primary securities held by that intermediary as assets in order to assess the risk attached to their investment. Such information may be costly to obtain and may involve substantial duplication of effort by individuals

who are potential depositors. However, by the simple device of prescribing a restricted range of assets eligible to be held by institutions which can label themselves (for example) savings banks, individuals are provided with required information at little cost. The government's monopoly in "label-issuing" is, because of its information content, a valuable resource, for which some price (such as adherence to prescribed portfolio range) can be expected to be paid by those wishing to use the label. Provided similar activities can be undertaken by other intermediaries who prefer not to comply with the regulations and hence are prohibited from using the label, and provided "free exit" from the "labelled" sector exists, it is difficult to see any costs of such regulation. Of course, the emergence of private firms supplying information about the risk characteristics of intermediaries may also improve efficiency - but it is not obvious that this is necessarily either a feasible or preferable alternative to regulation.

As a third example, consider the situation where the government acts as guarantor for funds placed with particular intermediaries, perhaps either because the availability of a risk free haven for some investors is viewed as a social objective, or because of externalities ensuing from the possible failure of particular intermediaries. To be specific, let us consider the provision of the Banking Act (section 12) which requires the Reserve Bank to protect depositors of the banks. Such a provision confers substantial competitive advantages on banks, since depositors need not concern themselves about such normally relevant issues as the gearing ratio of banks, nor need the banks issue deposit liabilities classified by priority ranking in the event of default. If the provision is to be retained, government restrictions on the type of deposit instruments issued may have a valid basis. Government may be envisaged

as acting in place of a private insurer of bank deposits, and the latter would most certainly require restrictions upon the nature of liabilities issued.

As a final example we may note that the existence of secondary markets in which "old" financial assets can be traded to bring about desired portfolio reallocations is crucial to a speedy transition from one equilibrium to another in financial markets. Yet, the development of secondary markets may be inhibited by imperfect information. For example, secondary markets in the liabilities of the household sector are lacking in Australia. Potential purchasers of such financial instruments will be inhibited by the costs of assessing the risks attached and suspicious of the motivation of the seller who is likely to have superior information about the riskiness of the asset. Consequently, the lack of secondary markets in particular assets may provide justification for portfolio regulations designed to encourage increased demand for these assets. Since the existence of a secondary market is a valuable attribute of an asset, interest rates on non-marketable assets will be correspondingly higher than those on marketable assets. Here, private and social benefits diverge and grounds for intervention may exist. Alternative forms of intervention are, of course, possible - including provision of insurance facilities to encourage the development of a secondary market or encouragement of the growth of credit rating agencies - but it is an (as yet) unanswered question as to which may be preferable.

These examples are, of course, purely illustrative, but are designed to indicate the complexities surrounding questions of efficiency in financial markets. "Some forms of government intervention" as the committee notes "... are expressly designed to improve the efficiency of the financial system". (para. 23.6) Whether any of the current set of

regulations are the appropriate method of so doing is another question.

4. Some Issues

The preceding section has indicated some areas in which, in my opinion, government regulation may be justifiable on grounds of efficiency consequences. These may be summarized as those areas in which regulation is associated with government insurance facilities, helps overcome information deficiencies, arises as a countervailing force when entry barriers exist, or is needed to ensure that private decisions reflect social costs and benefits. However, demonstrating that 'market failure' exists is not, of course, sufficient; the regulated environment must also be shown to yield net benefits. I now turn to a consideration of some particular regulatory issues considered by the committee.

(a) The Captive Market

The arrangements which have established a captive market for government debt seem inordinately difficult to justify. Their objective of reducing the cost of government borrowing programs (although some see them also as having prudential objectives) may be self defeating. Even though particular institutions are forced to hold larger than desired _proportions_ of their assets in government debt, it is conceivable (if perhaps unlikely) that their _total_ demand for government debt is lower than it otherwise would be for given interest rate structures, because of contractionary effects on the size of their portfolio. Moreover, captivity requirements may make the task of open market operations more difficult. Since the captive's holdings are likely (and appear) to be unresponsive to interest rate changes, the achievement of a given change in base money may require larger changes in government yields.

If a justification for such arrangements can be found, it would seem to lie in noting that government provision of non-excludable public goods must be financed somehow. Non-distorting taxes are generally seen as the first best alternative but, to the extent that they are impractical, indirect taxation of wealth holders via compulsion to hold low interest government debt may be a second (or probably much larger) best alternative. Moreover, to the extent that debt financing rather than taxation can lead to intergenerational transfers from future to current generations, the case for compulsory debt holdings at low interest rates may be strengthened. However, the ultimate results of such arguments are unclear and it is thus impossible, at this stage, to use them in support of the captive market arrangement. Consequently, I would argue for the removal of such arrangements.

(b) <u>Competitive Balance</u>

While I have much sympathy with the principle that "likes" should receive equal treatment from government, I find much difficulty in considering applications of this principle. For example, if government regulation is to improve costs on particular intermediaries, does equal treatment refer to costs imposed on owners of those intermediaries, their customers, or their staff.

This issue seems important when, as is the case with savings banks, building societies etc., intermediaries performing essentially identical functions have quite markedly differing institutional structures. Equal treatment, based solely on an examination of their functions, may be decidedly unequal in its impact on the relevant individuals. Indeed, as a more general point, I find the whole notion that <u>institutions</u>, rather than <u>individuals</u>, should receive equal treatment to be quite mystifying.

In this respect, two suggestions may be relevant. First, a case may exist for differential regulatory treatment of savings banks and building societies. Depositors with building societies are, in principle at least, acquiring a share of ownership - unlike depositors with savings banks. Consequently, the case for depositor protection would seem to involve different arguments in each case - and as a result, possibly different schemes. In addition, similar functions may be associated with quite different behavioural patterns between (say) co-operative and profit maximizing institutions. Regulations designed for the purpose of monetary policy may then be expected to differ between the types of institutions.

As a second suggestion, we may ask what is the appropriate entity to which a set of regulations should apply? Is it, for example, the bank or the bank holding company? To the extent that activities of bank affiliated companies can place the viability of the parent at risk (as we have recently seen), some form of compulsory gearing ratio for the parent, based on the scale of non bank vis a vis banking activities, may be desirable. However, while such a practice may guarantee the safety of the bank, (assuming that this is a desirable objective) it still leaves as unsolved the problem that public perceptions of the risk level of bank affiliated companies may yield these an unjustified competitive advantage.

(c) The Transition Stage

When reforms are decided upon, should they be gradually phased in, or all implemented simultaneously? This, I feel, may be one of the hardest decisions facing the committee (or at least those responsible for instituting its recommendations). Let me illustrate by one example.

The captive market regulations suggest that demand for government debt is artificially inflated at current interest rate structures. Removal of such regulations will then, presumably, lead to a higher equilibrium rate of interest on government debt. Announcement of a gradual phasing out of the regulations may seem desirable to minimize disruption in the bond markets, but may have the opposite effect. Non captive holders, recognizing that the removal of the regulations will create capital losses on bond holdings, may immediately reduce their holdings and thus force interest rates towards their new equilibrium before the regulations are relaxed. (Those readers more at home with the intricacies of rational expectations may be able to suggest possible conditions under interest rates will overshoot their long run equilibrium level). The consequences for the bond market may be the same as with instantaneous abolition of the regulations, except perhaps with regard to who bears the capital losses.

5. Conclusion

In this paper I have tried to emphasize that in recommending reform a balance needs to be struck between allowing for the complexities of the financial system and the need to simplify matters in order to understand the basic issues. Quite significant anomolies in current regulation exist, and the system may well be over-regulated. However, the appropriate direction of reform appears to resemble more a difficult winding mountain path, than a long straight freeway.