"Globalisation: the role of institution building in the financial sector"

G20 Case study: an Australian perspective

Abstract

This paper provides a case study of the development of Australia's financial system and its experience in the past two decades with deregulation of the financial sector.

Financial liberalisation in Australia was an important driving force in providing a competitive stimulus to the financial sector, enhancing technical, allocative and dynamic efficiency. It also provided benefits to the economy more broadly and provided the necessary conditions for Australia to become more closely integrated with the global economy, whilst accompanying parallel policy changes aimed at opening the economy to world markets.

While the deregulation process brought many benefits to Australia, the Australian experience suggests there are synergies in reform of different policy areas and gives insights into the appropriate sequencing of reforms.

The reform task is on-going given the fast rate of change in global markets. The challenge for policy-makers is to keep pace with market developments to ensure the regulatory environment continues to be relevant and appropriately balanced.

The Department of the Treasury and the Reserve Bank of Australia

September, 2003

1. Historical review

The Australian financial system evolved in five stages. The first stage was the introduction of financial institutions during the early colonial period in the 19th Century, where the influence of British institutions was a key driving force. The end of that period was marked by the 1890s depression which saw a major rationalisation of Australia's financial institutions. The start of the modern era of financial regulation can be traced back to the introduction of banking legislation in 1945 and the establishment of Australia's first central bank.

In more recent times, Australia has seen two major waves of financial reform. The first wave, in the 1970s and 1980s, involved a major deregulation exercise which transformed Australia's financial system. In keeping with other policy measures aimed at opening Australia to increased trade, investment and international competition. A second wave of reform in the 1990s sought to address new regulatory issues that arose in the post-deregulation period.

Financial sector reform did not occur in a vacuum but occurred in the context of a significant era of reform of the Australian economy. Reforms in other areas, and their relationship with the financial sector reforms, are also discussed in this section.

Foundations of the Australian financial sector

Origins of Australia's banking system

Australia's monetary and banking system originated in the 19th Century and was modelled on British laws and institutions. Commercial banking began in Australia in 1817 with establishment of the privately-owned Bank of New South Wales, which issued legal tender. This was followed in 1819 by the first savings bank, the New South Wales Savings Bank, which held for safekeeping the moneys of new arrivals to the colonies (Peat Marwick 1985: 1).

The number of banks expanded over the course of the 19th Century, including in the new territories of Victoria and South Australia. British banks took the lead in expanding the financial system of the Australian colonies. They introduced large amounts of capital, provided channels for the inflow of British investment, established foreign exchange markets, encouraged interest rate competition, and began the development of a branch banking network.

Growth in the banking sector was driven in the first half of the century by rapid expansion of the pastoral industry. The discovery of gold in the 1850s in Victoria was a driving force behind growth in the second half of the century. This latter period resulted in the establishment of more than 30 new colonial banks and several British banks. By the 1890s, more than 1000 branches had been established and retail branch banking became widespread.

The 1890s depression provided a watershed period in the history of Australian banking. During the 1880s, Australia saw increases in investment associated with extraordinary levels of

building activity and property market speculation. At the same time, banks took on higher levels of risk in order to maintain market share in the face of competition from non-bank financial institutions, such as building, pastoral and mortgage companies. Consequently, the collapse of the real estate market during the depression years led to a series of bank crashes and brought home to the banking industry the need for better prudential practices (Peat Marwick 1985: 1).

Between 1891 and 1893 only 10 out of 64 banks were not forced to close or refuse payment for longer or shorter periods (Gollan 1968: 28). The result was the rationalisation of the industry into a smaller number of viable banks. It also led to pressure for a national bank along the lines of the Bank of England and for a paper currency in order to stabilise and protect the financial system (Gollan 1968:18). However, action for a central bank would have to await Federation (Lewis and Wallis 1997: 49).

Evolution of the central bank

With the Federation of the Australian states into the Commonwealth in 1901, the Commonwealth parliament assumed power to make laws with respect to banking and currency. In the two months following the inauguration of the Commonwealth, banks were invited to give their opinions on a banking act and in particular on control of note issue. The debate over establishing a national bank and its functions continued for the next decade as various models were considered.

The Commonwealth Bank was created in 1911 under the *Commonwealth Bank Act*. It was empowered to conduct both savings and general banking business supported by a Federal government guarantee. The Commonwealth Bank became the first bank involved in both trading and savings bank activities (Peat Marwick 1985:2). The Commonwealth Bank did not specifically have a central banking remit and it was not responsible for note issue, instead it was established as a vehicle to provide competition for commercial banks and to keep accounts of the Commonwealth government.

The Government took over note issuance from the private banks in 1910 and transferred that responsibility to the Commonwealth Bank in 1924 (the function was managed by the Australian Treasury in the interim period). Increasingly, the Commonwealth Bank became banker to governments.

The plan had been to allow the Commonwealth Bank to evolve into a central bank as had the Bank of England. In 1924, under an amendment to the *Commonwealth Bank Act*, a Commonwealth Bank Board was established and the Bank was given the power to discount bills and to establish a discount rate. This was intended to provide the footings for central banking, despite it taking 50 years for the discount rate to become an instrument of monetary policy (Lewis and Wallis 1997: 49).

Australian banks fared better during the depression of the 1930s than the 1890s depression, with relatively few bank closures and consolidations. However, the 1930s depression did

highlight the links between financial system stability and economic growth and employment. As a result, banking activities came under close scrutiny and there was a Royal Commission into Money and Banking in 1936-37. The Commission recommended a number of measures to support the stability of the financial system in Australia. Most of these measures were adopted in the Bank Act and Commonwealth Bank Act (1945)[1]. The Commonwealth Bank was given powers to operate formally as a central bank by allowing it to fix interest rates, control lending of private trading banks and to demand that some of the private trading banks' funds be held with it. As well, the Act regulated the spread of banks by making licensing mandatory (Peat Marwick 1985: 2).

In the ensuing period, tension emerged between the Commonwealth Bank's central bank role and its commercial role, with the private trading banks arguing that the Commonwealth Bank had an unfair advantage in the banking business. This eventually led to the separation of the Commonwealth Bank's trading and central banking activities, resulting in the formation of the Reserve Bank of Australia (RBA) in 1960, following the passage of the Banking Act (1959) and the Reserve Bank Act (1959).

Origins of financial deregulation

The post-war regulatory system essentially sought to achieve its monetary and supervisory goals via direct restraints on the activities of banks. The regulatory regime that was in place during this period restricted banks' operational flexibility and their ability to compete. For example, interest rate ceilings on deposit accounts restricted banks' ability to attract funds. Similarly, lending was restricted through guidelines on trading bank approvals. Savings banks were constrained in their ability to lend for housing by the requirement to hold a majority of assets in cash, government securities or deposits with the central bank.

The role of non-bank financial intermediaries grew to fill the gaps caused by restraints on banks – for instance merchant banks to service corporations and building societies to service the home lending market. Not only did the market share of commercial banks decline over the period 1955 to 1980, but bank assets declined as a share of GDP. This had important implications for the conduct of monetary policy, which relied on direct controls on banks, and also caused concerns from a prudential perspective

The Australian authorities were conscious of this trend at an early stage and a number of steps towards deregulation were taken during the 1960s and 1970s in an effort to bolster the position of banks and to begin to establish means by which influence could be exerted on the broader financial system. For instance, maximum rates on large overdrafts were removed in 1972 and interest rates on certificates of deposit were freed up in 1973, allowing banks some scope to

---

[1] There was a legal challenge of aspects of the legislation dealing with the ability of the central bank to be imposed as banker to state and local government authorities. When this challenge succeeded it called into question the legal basis of the legislation as a whole and led to the government seeking to nationalise the banks. It was ultimately defeated in this objective by a High Court challenge.

manage their liabilities. However, regulation was very much focussed on the domestic market and competition among domestic institutions.

Freeing up regulation in some areas, however, had the effect of increasing pressures on the regulations that remained. By the 1970s, these pressures were being aggravated by the increasingly interest-sensitive nature of capital flows – largely reflecting the establishment of merchant bank subsidiaries of foreign banks, which had access to funds from their overseas parent organisations. These volatile capital flows, together with a pegged exchange rate, complicated efforts to control domestic liquidity and aggravated the effects of differential regulation between various parts of the financial system. The need for the central bank to fund any shortfall in raising government debt as a result of inefficient debt-raising mechanisms added to problems with liquidity management.

Against this background, the Government instigated a major review of the Australian financial system – the Campbell Committee inquiry in 1979 – the first major wave of financial sector reform. This inquiry responded not just to the increasing importance of non-bank financial institutions (NBFIs) and the difficulties with operating monetary policy, but also answered the need for a review and assessment of the range of regulatory changes that had occurred almost on an *ad hoc* basis during the 1960s and 1970s.

The Campbell Committee inquired into the regulation, control and structure of the financial system in order to promote efficiency, while at the same time ensuring the stability of the system. The Inquiry recommended the removal of regulation which undermined efficiency, such as interest rate controls and lending restrictions, and the strengthening of prudential oversight to bolster stability. In its report, the Campbell Committee argued that deregulation would increase efficiency of the financial system in three ways:

- it would improve *allocative efficiency* by removing the barriers to the flow of savings into the highest-yielding investments;
- it would increase *operational efficiency* by reducing the very wide interest rate margins maintained by the Australian banks; and
- it would enhance *dynamic efficiency* in the form of greater financial innovation to meet the needs of consumers of financial services.

The Committee suggested a number of reforms that included the removal of ceilings on interest rates on bank deposits, the lifting of maturity restrictions on bank deposits, the introduction of a tender system for selling government securities, the relaxation of portfolio controls on savings banks, relaxation of capital controls and removal of restrictions on the entry of foreign banks. These recommendations were implemented in the first half of the 1980s.

A further recommendation of the Campbell Committee was the floating of the Australian dollar. At the time, there was increasing recognition in Australia and elsewhere, that it was not possible to pursue an independent monetary policy while defending a fixed exchange rate with

mobile capital. This broader concern, in conjunction with short term pressures associated with speculation against the Australian dollar, led to the floating of the currency in 1983.

As an entire generation had known only a highly-regulated environment, the Government understandably allowed time for the business community, bureaucracy and general community to absorb the Campbell Report. In 1983, the newly elected Labor Government adopted an investigation into the financial system having regard to the Campbell Report and the new government's economic and social objectives. The Report of the Review Committee (the Martin Report) strongly endorsed the major recommendations of the Campbell Committee and from then on the Government's commitment to deregulation was unreserved and, in rapid sequence, major recommendations of both of the reports were implemented (Lewis and Wallace 1985).

Developments post-deregulation

The period of rapid deregulation in the first half of the 1980s sparked equally rapid change for Australia's financial sector. Over the period 1983 to 1988, the amount of capital in the sector rose from A$4.5 billion to A$20 billion, the number of banking groups operating in Australia rose from 15 to 34, and the number of merchant banks increased from 48 to 111.[2] Credit also expanded rapidly, growing by 147 per cent between 1983 to 1988, but this brought with it some unanticipated problems.

The lowering of barriers to entry into financial markets increased competition, which in turn facilitated technological innovation and enhanced consumer choice. Deregulation helped improve the efficiency of the sector by focusing activity towards innovation and away from the unproductive activity of circumventing outdated regulations.

Deregulation accelerated the forces of globalisation on the Australian market. While technological change lowered the costs of cross-border transactions, deregulation removed impediments to such transactions, allowing markets to become more global in nature. This added to the pace of change in financial markets.

These changes also created new challenges for regulators. Innovation in product design blurred the boundaries between financial instruments and institutions. With regulation still following largely institutional lines, providers were able to exploit regulatory gaps – for example there was a further proliferation of non-bank financial institutions offering savings products which had the competitive advantage of not being subject to the same stringent regulation as the banks. Moreover, non-financial service competitors, such as retailers, airlines

---

2 While one of the objectives of the Campbell Report was to put banks back on an equal footing with other financial institutions, some disadvantages remained for banks for some years, which may have influenced the growth in merchant banks. These including requirements to hold statutory deposits with the central bank and a proportion of assets in notes and coin or government securities. The establishment of a merchant bank was also a popular means for foreign banks to establish a presence in Australia prior to the decision to allow foreign bank branches in 1992.

and telecommunications companies, were entering the industry and offering financial services to consumers. These changes in the financial system led to products and distribution channels expanding beyond the traditional categories of banking, insurance and stock broking. This placed pressure on regulation to ensure competitive neutrality in the treatment of like products offered by different institutions.

Increasing consumer sophistication was associated with new products and, importantly, the greater availability of information about those products. This factor, together with demographic factors (such as the ageing of the population) and government initiatives to promote retirement savings, led to changing consumer demands. In particular, it saw a relative decline in the importance of deposits as a form of savings.

In addition to these broader forces of change, specific developments in the post-deregulation environment provided pressure for further review of the financial system.

The level of corporate gearing increased significantly over the 1980s. Underlying this trend was a rise in the number of highly leveraged corporate takeovers from 1984-87, while credit growth post 1987 was driven in large part by a property boom.

A number of factors contributed to lower credit quality. Banks took some time to adjust risk assessment procedures. In the deregulated environment, banks were able to take on higher risk borrowers and also needed to take account of exchange rate and interest rate risk to a greater degree than before (Valentine 1991). In addition, during the late 1980s high inflation, together with a taxation system that provided incentives to borrow to finance capital investments, led to large amounts of over-borrowing as investors took advantage of increasing asset prices.

As interest rates rose over the late 1980s, the fall in credit standards began to manifest itself in significantly higher levels of non-performing loans and write-downs, resulting in substantial losses at two of the four largest banks, the re-capitalisation or takeover of some State government owned banks, and the closure of some NBFIs.

Foreign banks also carried a significant level of non-performing loans during the recession of the early 1990s. The share of non-performing loans to total assets peaked at 12 per cent for the foreign bank sector, which was twice the peak in the broader system. The higher proportion of non-performing loans in the foreign bank sector, notwithstanding the experience of their parent institutions, suggest that actions of the domestics banks in protecting market share might have contributed to foreign banks taking on riskier business. The domestic banks began reacting to the possibility of competition from foreign banks through mergers, acquisitions and increased lending in the early 1980s, well before deregulation and before any foreign banks had actually entered the market.

Managing country currency risk

The move to a floating exchange rate in 1983 came in response to pressure from capital inflows, rather than capital outflows as is more frequently the case in other countries. Nevertheless, there was a learning phase for agents to recognise and manage currency mismatches.

Faced with new financial freedoms in the immediate post-float period, some agents began to borrow unhedged in foreign currencies to take advantage of significantly lower interest rates overseas. In particular, many farmers and small businesses borrowed substantial amounts in Swiss francs. When the exchange rate subsequently fell sharply, in 1985 and 1986 (by about 40 per cent), these borrowers faced large losses, and many went out of business.

The immediate issue that led to the problems of the Swiss franc loans was one of risk recognition. The Australian experience was that publicity surrounding the problems of farmers played an important role in educating the corporate sector more broadly about the risks and the need to manage them.

While Australia worked through this period without a full-blown banking crisis, the ramifications lasted for some years. The economy's recovery from the 1990-91 recession was slowed by the need for banks and corporates to repair their balance sheets. At the same time, the Australian Banking Industry Inquiry in 1991 was set up to examine concerns about the performance of the banking sector in a deregulated environment. As well as many recommendations with a competition focus, the report sought to strengthen the supervision of banks to address shortcomings that had been highlighted by the late 80s/early 90s episode.

Many issues raised throughout the 1980s and 1990s were overcome with the appropriate regulatory adjustments, such as the establishment of coordinated supervision of banks and non bank financial intermediaries as well as the introduction of regulations into the insurance and superannuation industries. The financial system was transformed over this period and continued to undergo sweeping change. Against this background, the Government decided in 1996 to establish a new inquiry to review these developments, to consider the factors likely to drive further change in an increasingly more global environment, and to make recommendations for possible further improvements to the regulatory arrangements.

The policy response

Financial system reform – the second wave

In 1996, the Government commissioned the Financial System Inquiry, the Wallis Inquiry. The Inquiry was commissioned to make recommendations on regulatory arrangements that would respond to the developments of the previous decade and ensure an efficient, responsive, competitive and flexible financial system. Specifically, the underlying objectives of the Wallis Inquiry were:

- to promote greater efficiency through enhanced competition; and

- to maintain confidence and stability in the financial system while preserving the ability to be responsive to innovation and market developments.

The Inquiry found that the intensity of prudential regulation should be proportional to the degree of market failure which it addresses, but should not involve a government guarantee over any part of the financial system. Fundamentally, it is the responsibility of the board and management of financial institutions to ensure that the financial promises made to consumers are kept. Prudential regulation and supervision should seek only to add an additional discipline by promoting sound risk-management practices by firms and providing for early detection and resolution of financial difficulties.

The Inquiry considered that while prudential regulation is warranted in certain limited circumstances, its more intense forms would need to be wound back over time and the regulatory focus shifted towards the conduct of market participants and disclosure of information.

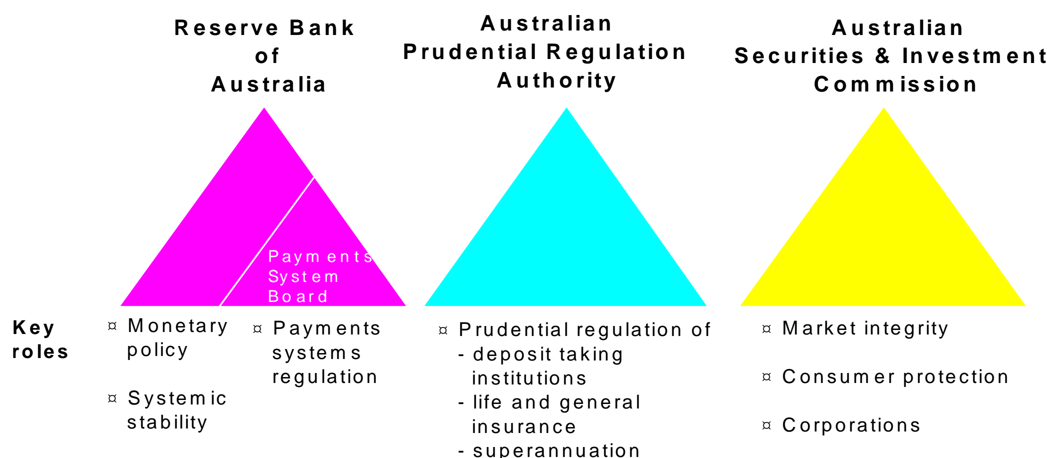
The financial regulation framework recommended by the Wallis Committee in its Final Report of March 1997 was intended to be flexible in the face of ongoing change in the financial sector. In general, this evolution in the market requires a shift in regulatory philosophy towards an increased reliance on disclosure and market-based signals and away from highly specialised prudential or industry-specific regulation.

Implementation of reforms

The Australian Government accepted a majority of the recommendations of the Wallis Inquiry (Costello 1997). The key recommendation was a new organisational framework for the regulation of the financial system. The Inquiry recommended a model of regulation based on functional objectives, with three 'peaks' – a single prudential regulator, a regulator for conduct and disclosure, and an institution responsible for systemic stability and payments. The regulatory framework prior to the Wallis Inquiry was based on a sectoral approach, where different regulatory institutions had responsibility for specific industries within the financial sector.

The reforms built upon the previous regulatory framework that was based on four institutional regulators and replaced them with three agencies established on functional lines, as can be seen in Figure 1.

Figure 1: Key regulatory agencies in Australia



Under the Wallis reforms, the Reserve Bank of Australia (RBA) is responsible for monetary policy, the overall stability of the financial system and the regulation of the payments system. The RBA focuses on maintaining stability in the financial system (including the payments system, which is an important contributor to stability). The RBA retained responsibility for systemic stability, as any system wide problems would likely require liquidity support by the monetary authorities. The RBA liaises extensively with the other financial sector regulators in monitoring systemic stability.

- The principal change to the RBA's functions was the removal of responsibility for prudential supervision of banks and depositor protection. This change assisted to clarify that while the RBA may intervene to assist systemic stability, its balance sheet was not available to guarantee deposits. It also clarified the accountabilities for the regulatory task.

The Australian Prudential Regulation Authority (APRA) became responsible for the prudential regulation of all deposit-taking institutions, general insurance, life insurance and superannuation. This resulted in all prudentially regulated entities in the financial system being brought within the Commonwealth jurisdiction and regulated by a single agency. This allowed for the removal of artificial and anti-competitive distinctions between different types of entities providing similar products and assisted the regulation of financial service conglomerates. Prior to the Wallis reforms, prudential regulation was carried out by several different agencies at both the Commonwealth and State government levels.

The Australian Securities and Investments Commission (ASIC) became responsible for maintaining market integrity, consumer protection, and the supervision of companies across the financial system. These responsibilities were transferred from several different regulators

with the intention of minimising inefficiencies, inconsistencies and regulatory gaps that undermined effective competition in financial markets.

To effectively perform their role, the regulators were given substantial operational independence from the Government in administering legislation and in dealing with particular cases in prudential supervision or conduct and disclosure. The financial sector regulators have a clear charter of objectives and accountabilities laid out in their enabling legislation.

Accountability for the operational or day-to-day supervision of financial institutions and markets lies with the regulators. The roles of the Australian Government ∝ through its ministers within the Treasury portfolio ∝ includes setting the broad policy direction and priorities for regulation of the financial sector and bringing proposals to the Parliament for new legislation or amendments to legislation.

Additionally, in March 1998 the Government established a high level Financial Sector Advisory Council (FSAC). FSAC is a non-statutory body that brings together a range of financial market participants to provide advice to the Government on policies to facilitate the growth of a strong and competitive financial sector.

The move in Australia to match the structure of the regulators to their functional objective and to consolidate supervision of financial institutions is consistent with international developments. Amongst OECD countries, Canada, Denmark, Norway, Sweden and the United Kingdom moved in the late 1980s and early 1990s to establish a single prudential regulator separate from the central bank. The post-Wallis regulatory structure has also provided a model for changes in other countries. A number have established a single financial sector regulator, while others have established arrangements similar to Australia.

Insurance sector reforms

Australian private sector general insurers are regulated by APRA under the *Insurance Act 1973* (the Insurance Act). Over time, the prudential arrangements set out under the Act were increasingly considered to be blunt and unresponsive in an environment of significant market and regulatory developments, including globalisation, convergence and improvements in domestic and international regulatory best practice. These changes had driven the need for more flexible and sophisticated ways for regulators to undertake prudential regulation of the general insurance sector. In 2000, the Government announced that the regulatory framework for the general insurance industry would be reformed. The new framework commenced on 1 July 2002, with capital requirements to be phased in by 1 July 2004.

The overarching objective in developing a new framework for the prudential supervision of general insurance was to provide a more secure environment for policyholders. The revised Insurance Act strengthens the requirements for general insurers to conduct insurance business and increases APRA's enforcement powers to undertake its regulatory responsibilities. Consistent with other financial sector reforms, the amendments are designed to ensure the Insurance Act is more flexible and less prescriptive than the earlier legislation, allowing the prudential regime more easily to accommodate market developments over time. The power

for APRA to set standards provides for the framework to be responsive to changes in commercial and international best practice.

Broader policy environment

Reform of the financial sector cannot be fully understood without reference to the broader policy environment given the interactions between different strands of policy. For example, deregulation was in part aimed at making monetary policy more effective, but in the process led to fundamental changes in the way monetary policy was formulated and implemented. The removal of exchange rate and capital controls, was consistent with Australia's more outwardly-focused policy orientation. However, it put subsequent pressures on the current account and had implications for the appropriate stance of fiscal policy. Moreover, developments in the financial sector placed pressures on other areas of regulation, such as competition policy.

Monetary policy

During the late 1970s and early 1980s, monetary policy in Australia was guided by a target for annual growth in M3 – referred to in the Australian context as a "conditional projection". This was in line with the practice in many other countries at the time. However, financial deregulation saw the demand for money, as traditionally defined, become increasingly unstable, and the relationship between monetary aggregates and inflation and nominal income break down. Monetary targeting was abandoned in 1985. In the absence of alternatives, this left monetary policy to be set on a discretionary basis for the next few years, although a "checklist" of economic variables was adopted for a period.

The persistence of relatively high inflation in Australia through the late 1980s and the desire for a more credible and intellectually robust framework for monetary policy saw Australia adopt an inflation targeting regime in 1993. This took a less rigid form than some other countries, with the target specified as an inflation rate between two and three per cent on average over the economic cycle. This was affirmed in the *Statement on the Conduct of Monetary Policy* signed by the Treasurer and the Governor of the Reserve Bank of Australia in August 1996. The Statement also formally established the independence of the Reserve Bank.

There is little doubt that the additional market scrutiny that came with deregulation and increasing integration with global markets added to the pressure to get the monetary policy framework right. These same forces brought about equally dramatic changes in the Reserve Bank's operational framework, which in turn put in place the basis for greater operational independence. The freeing up of banks' activities meant the abandonment of many of the early tools of monetary policy – many of which were in the hands of the Government, rather than the central bank. In this new world it became possible for monetary policy to operate via open market operations aimed at setting the overnight cash rate. This, for the first time, provided a purely market-based mechanism for monetary policy, and one which was entirely in the hands of the central bank.

Fiscal policy

Following the floating of the Australian dollar and removal of capital controls there was increasing focus on the size of Australia's current account deficit, and the savings-investment imbalance underlying the deficit. There was much public debate on the 'twin deficits' of the current account and the federal budget and pressure for a medium term fiscal strategy that boosted public savings and reduced pressure on the current account.

Fiscal policy was also contributing to high domestic interest rates (Comley, et al, 2002) and making the economy more vulnerable to changes in investor confidence. Effectively, Commonwealth finances were seen as imposing a 'speed limit' on economic growth by creating negative perceptions about investment in Australia.

In the 1996-97 Budget the Commonwealth Government announced that it would implement a Charter of Budget Honesty. The charter was not to articulate any specific rules or objectives for fiscal policy but specified a number of transparency-oriented requirements and guiding principles for the operation of fiscal policy. In 1998, the government adopted an explicit strategy to maintain budget balance, on average, over the course of the economic cycle.

Further, the Commonwealth Government undertook major reform of the taxation system in 2000 with the introduction of a 'goods and services tax' (GST) in July of that year based on the 'value added tax' model. The GST removed a number of inefficient specific taxes and provided a broad base indirect tax system to ensure a secure revenue base into the future. Reform of the taxation system has provided a more competitive and robust foundation in face of increasing global competition for investment (OECD 2000).

Review of the Commonwealth Government securities market

As a result of the medium term fiscal strategy of maintaining budget balances, on average, over the course of the economic cycle (see Chart 1), combined with a program of privatisation, the Government since 1996 has significantly reduced its level of net debt. Net debt has fallen from a peak of 19.1 per cent of GDP or around A$96 billion in 1995-96 to an estimated 4.3 per cent of GDP or around A$32 billion in 2002-03. Net debt is expected to fall to 3.7 per cent of GDP or around A$30 billion in 2003-04.

Reductions in gross debt outstanding have accompanied the decline in net debt. This is reflected principally in declining Commonwealth Government Securities (CGS) on issue (see Chart 2).

Chart 1: Commonwealth General Government – underlying cash balance

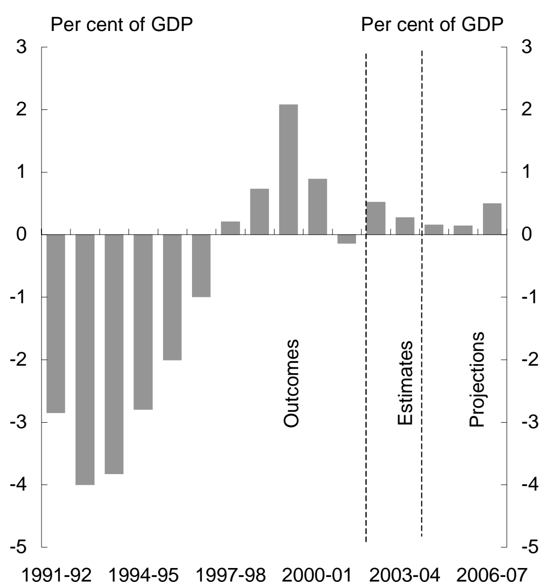
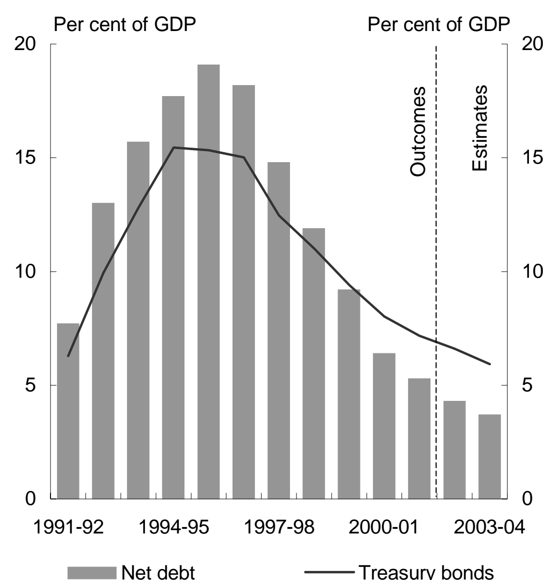


Chart 2: Commonwealth General Government net debt and Treasury bonds on issue



Source: The Commonwealth Treasury (2003), *Budget Strategy and Outlook 2003-04: Budget Paper No. 1.*

The reductions in CGS on issue raised questions among some market participants about the future viability of the CGS market. The Government acknowledged these concerns in the 2002-03 Budget and undertook to examine the issue in consultation with key stakeholders.

The Review concluded that, while financial markets may innovate in the absence of CGS, there was merit in maintaining CGS operations. It was identified, in particular, that the CGS market plays an important role in managing interest rate risk (the risk associated with adverse movements in interest rates), and contributes to a lower cost of capital in Australia. Further, in the absence of CGS, the Australian financial market may become less diversified and more vulnerable during periods of instability. Accordingly, on the basis of its findings, the Government announced as part of the 2003-04 Budget that it would maintain sufficient CGS on issue to support the Treasury bond futures market. As such, the gap between Treasury bonds on issue and net debt is likely to increase in the future.

Trade policy and competition policy

As noted, at the same time as it was deregulating its financial sector, Australia was reforming other sectors of its economy in response to the more outward-orientation of the domestic policy framework that began in the 1970s. The lowering of tariff barriers and rationalisation of industry assistance during the 1980s provided further impetus to the globalisation of the economy, and transformed the traded goods sector of the economy. As a result, Australia's trade intensity (exports plus imports of goods and services as a proportion of GDP) rose from 30 per cent of GDP in 1983-84 to 43 per cent in 2001-02.

Increased international competition led to pressure for reform of the non-traded goods sectors of the economy, sectors which were important to international competitiveness as they supplied inputs to exporters. The National Competition Policy introduced in the 1990s brought together a range of reforms of key infrastructure at the Commonwealth and State levels to enhance competition and improve the regulation of monopolies.

Globalisation changed the nature and definition of markets, and this had particular implications for mergers policy. Mergers policy has increasingly had to recognise the importance of the level of import competition and international competitiveness of firms seeking to increase their market share. This has taken place in an environment where the general mergers policy has been overlaid with a 'four pillars' policy, which prohibits mergers between Australia's four major banks.

Taxation reform

Australia's business tax arrangements have been modernised and improved. The centrepiece of these reforms has been the significant reduction in company tax rates to an internationally competitive 30 per cent. Capital gains tax changes have provided further efficiencies by removing indexation and replacing it with a halved rate of tax for individuals and trusts and exempting one third of the gain for superannuation funds. As a further measure, tax rates for different financial institutions were aligned as part of the business tax reforms which started in 1999. These tax rate reductions were funded by complementary measures, such as the removal of accelerated depreciation, which broadened the business income tax base.

Australia recently made changes to its tax treaty with its most significant investment partner the United States through an amending Protocol which entered into force on the 12 May 2003. The Protocol provides opportunities to significantly enhance the international competitiveness of Australian businesses, further improve Australia's standing as a global financial centre and increase trade and investment flows between Australia and the United States.

The Protocol represents a significant advance in the provision of a competitive tax treaty network for companies located in Australia and investing in the United States, in particular, through the reductions it makes in rates of withholding taxes.

Other notable tax treaty developments recently undertaken by Australia include the update to the tax treaty with Canada, completion of a new tax treaty with Russia and completion of a Taxation Code as part of the Timor Sea Treaty with East Timor. Negotiations for a revised double tax convention between Australia and the United Kingdom are close to conclusion.

Corporate governance

In March 1997 the Government announced its Corporate Law Economic Reform Program (CLERP). The program was developed in response to two key factors that revealed inadequacies in corporate regulation at that time.

The first of these factors was the increasing globalisation of capital markets. Liberalisation of world capital markets in combination with technological developments in information and telecommunication industries have fundamentally altered the nature and operation of business and the financial system.

The worldwide liberalisation of trade and capital markets resulted in Australian firms being increasingly exposed to international competition and it was considered vital that Australia have a regulatory framework that permits business to respond to challenges posed by changes in the international marketplace. In addition, changes in investor behaviour, which were reflected in growing financial sophistication, required a reassessment of the regulatory framework.

The second, closely related factor was the perception that Australia's business law had not kept pace with changes in the structure and operation of capital markets and business environment.

A review of Australia's corporate regulatory framework was considered necessary in order to ensure Australia's business laws were not placing undue compliance burdens on business in Australia. The evidence suggested that the existing framework constrained business activity and did not take account of the complexity facing management of large enterprises. The imposition of unnecessary costs inhibits business start-ups and development, and increases costs to business, investors and consumers alike.

In response, the CLERP reforms have facilitated business and financial markets through changes to the accounting standard setting infrastructure, financial product disclosure and licensing requirements, company takeovers as well as directors' duties and governance more generally. The CLERP process is ongoing, with changes currently planned in relation to corporate disclosure and insolvency rules.

One of the CLERP initiatives, The Financial Services Reform Act, put in place a harmonised licensing, disclosure and conduct framework for all financial products, markets and service providers. It is designed to develop a more efficient and flexible regime for financial products and markets within an integrated framework. This streamlined regulatory regime for financial markets and clearing and settlement systems will improve information disclosure to investors and overtime will reduce administrative and compliance costs.

Companies that provide financial services need only one type of licence – an 'Australian Financial Service Licence'. The regime provides that financial services providers must be properly trained and must comply with high standards of disclosure. Through the combination of licensing, conduct and disclosure obligations, consumers are better protected and able to determine the basis for the financial advice they receive.

2. Benefits of reforms

Assessment of the economic benefits from reforms to financial regulation in Australia must be considered in the context of several factors.

First, deregulation did not occur in a policy vacuum ∝ it is not possible to isolate the role of financial deregulation from other developments over the 1980s and 1990s which contributed to changes in the financial system. This includes the range of other policy reforms in Australia over the period and factors unrelated to regulatory reform such as globalisation, the introduction of new technologies and convergence.

Second, the hard data required to assess the effects of deregulation are, in many cases, unavailable or incomplete. Therefore, the analysis often relies, of necessity, on more qualitative observation.

Finally, it is difficult to identify the benefits flowing from more recent reforms such as those following the Wallis Inquiry and the changes to the regulation of general insurance. A number of these reforms have only recently come into effect or are set to come into effect in the near future.

The benefits flowing directly from the reform of financial regulation can not be precisely identified or quantified in the Australian case given their integration with a wide range of other policy reforms aimed at opening up the Australian economy to international competitive forces. Nevertheless, it is clear that there have been improvements in financial sector performance over time. However, it should also be noted that the increases in competition that have flowed from some reforms have taken time to eventuate, particularly in the retail banking sector. The benefits that have been evident include improved efficiency by financial service providers and increased choice in financial services available to consumers. There is also evidence that the streamlining of the regulatory framework has reduced the relative cost burden of financial regulation.

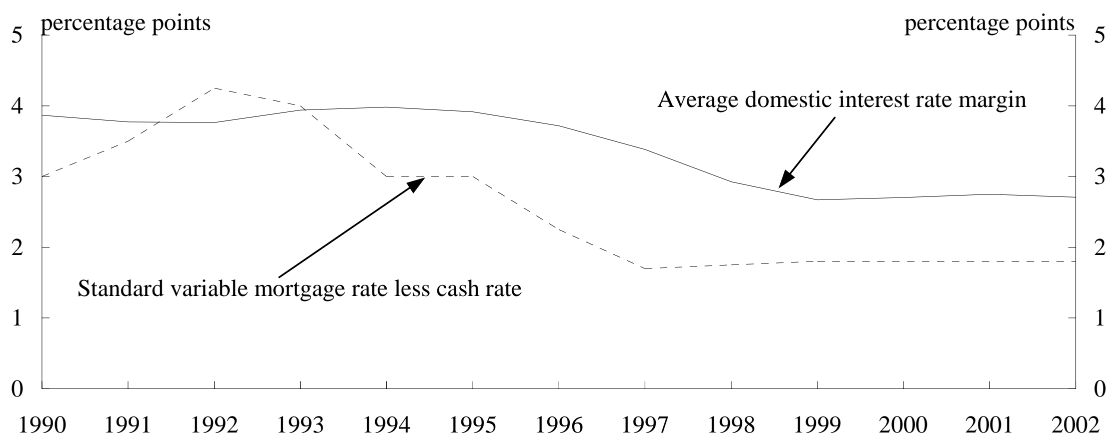
Increased competition

The reforms to financial regulation implemented over the past two decades have promoted competitive pressures across the financial sector. In particular, competition in markets, such as home and personal lending, has been enhanced by a number of changes. These include the entry of foreign banks into the Australian market and the establishment of specialist providers in the home lending market.

It should be noted that while the entry of foreign banks enhanced competition in wholesale markets they have struggled to make inroads in retail markets. In particular, it remains the case that the provision of finance to small businesses is concentrated at the four major banks. Also, increased competition in a number of instances took a while to come through – suggesting that it takes both deregulation and appropriate technology (which reduces the costs faced by new entrants) to produce an effective increase in competition.

Bank net interest rate margins provide an indication of overall profitability and the underlying level of competition. These margins are calculated as the difference between the average interest rate banks charge on their loans and the average rates they pay on their deposits. Over the past decade the net interest rate margin has fallen from around 4 percentage points to around 2¾ percentage points. The fall in the margin between rates for residential mortgages in Australia and short-term money market rates has been even more pronounced. The margin between these rates has declined from over 4 percentage points to around 1¾ percentage points (see Chart 3).

Chart 3: Bank net interest rate margins



Source: *Reserve Bank of Australia Bulletin* (2003), 'Banking fees in Australia'.

The rate of decline in these margins was most pronounced over the second half of the 1990s, largely as a result of heightened competition in the home lending market. The pressure on bank margins reflects falling barriers to entry facilitated by financial market and technological innovation which, among other things, provides non-bank competitors with alternative ways of financing their lending (that is, through securitisation), accessing customers and distributing products (Gizycki and Lowe 2000).

Efficiency benefits

There is evidence that the increase in competitive pressures that have flowed from the process of financial regulation reforms has contributed to improved efficiency in the financial sector over time. In particular, partial indicators point to gradual improvements in allocative and technical efficiencies in a number of sectors including retail banking.

In the banking sector, prior to the Campbell regulatory reforms, interest rate and maturity controls resulted in a pricing structure under which most retail payments and transaction services were provided free of charge. The costs of these services were offset against lower interest rates on deposits. As a result of these controls, the banking system practiced

considerable cross-subsidisation among different products and customer groups. These cross-subsidies created distortions in pricing signals.

During the 1990s the pricing of these banking services began to reflect more closely the 'user pays principle', thus creating stronger incentives for allocative efficiency improvements. For example, an extensive range of fees and charges for retail transaction accounts has been introduced by institutions providing deposit-taking services. These fees and charges will improve allocative efficiency to the extent that they more closely reflect the underlying cost of providing the services.

The narrowing of bank interest rate margins has also contributed to improvements in allocative efficiency by ensuring that the price of loans more closely reflects the cost of funds. The benefits to customers from reductions in banks' interest rate margins over the past decade have more than outweighed the cost of fees and charges levied (RBA 2003).

There is also evidence that increased competition in the financial system has given financial service providers incentives to reduce production costs (increase technical efficiency). Developments in technical efficiency over time can be broadly approximated by changes to operating expenses of financial service providers.

The Wallis Inquiry noted that, notwithstanding the rise in financial assets as a share of GDP, the contribution of the financial sector to GDP has been declining. That is, the financial sector has been managing a greater amount of assets with fewer resources. The Inquiry found that these declining costs are primarily due to lower employment in the financial sector, driven by technological restructuring and enhanced efficiency. Increased competition in the financial sector has provided an impetus for domestic institutions to reduce their costs of production.

As a result of increased efficiency, operating expenses of the domestic banks (as a proportion of total assets) have been gradually trending downwards from just over 3 per cent of total assets in 1987 to below 2½ per cent of total assets in 2002 (KPMG Financial Institutions Performance Survey 1995, 1996 and 2002). It should be noted that a range of factors beyond increased competitive pressures would have influenced operating expenses. For example, subdued wage inflation, strong asset growth and the sharp increase in the volume of high-value low margin business.

Deregulation has also seen significant 'dynamic efficiency' benefits from product innovation. Changes to financial regulation in the 1980s such as the removal of controls on interest rates and term deposit products and the entry of foreign banks into the domestic market increased both the range of products which banks could offer and the number of competitors in the finance sector. The competitive pressures on financial service providers to meet customer needs have been further enhanced by the arrival of niche, non-bank, service providers in several profitable markets. The improved range of products available to consumers is highlighted by developments in debt and credit products.

There have been considerable improvements in the range and sophistication of debt products available to consumers. During the 1980s deposit-taking institutions were the main source of home finance. These institutions offered, on average, two varieties of mortgage products, which had limited flexibility in terms and conditions. By 1996, consumers were able to choose from approximately 1,760 differentiated mortgage products offered by a range of suppliers. This figure includes a spectrum of residential, investment and equity mortgages offered by 150 financial institutions, each offering an average of 12 different mortgage products. Moreover, products available included elements such as fixed and variable interest rates, redraw facilities and arrangements for offsetting interest between savings and loan balances (RBA 2002).

There have been similar improvements in the deposit products available to consumers. Prior to regulatory reforms, deposit products available to consumers were limited to transaction accounts, savings accounts, savings bank investment accounts and term deposits. The introduction of cash management accounts during the 1980s substantially improved the rate of return available on short-term retail deposits. The choice of deposit products available to consumers has subsequently increased, with almost 1,800 different deposit accounts on offer at the end of 1996.

A further indicator of the improved services for consumers has been the diversification of delivery platforms for financial services. During the early 1980s, the predominant mechanism for delivery of financial services in Australia was the traditional branch network. However, over the late 1980s and 1990s this situation altered significantly as financial service providers quickly embraced the opportunities to improve services facilitated by the development of new technologies. The incentive to use these new technologies for service delivery primarily arose from the drive by financial service providers to reduce the costs of service delivery.

As shown in Table 1, there has been strong growth in the accessibility of financial services for consumers since 1997. In particular, there has been a decline in the number of physical access points such as branches and agencies. However, this trend has been more than offset by the strong growth in electronic access points such as Automatic Teller Machines (ATMs) and Electronic Funds Transfer at Point of Sale (EFTPOS). Australia's take-up of EFTPOS technology, in particular, is high by international standards.

Table 1: Access to financial services

Method	Jun-98	Jun-99	Jun-00	Jun-01	Jun-02
Bank branches	6,121	5,358	5,003	4,712	4,728
Non-bank branches	1,391	1,358	1,208	1,428	1,236
Bank Agencies	6,992	6,528	5,043	*	*
Non-bank agencies	1,760	1,417	887	*	*
GiroPost	2,627	2,724	2,814	2,814	2,962
ATMs	8,182	9,387	10,818	11,915	11,714
EFTPOS	164,199	265,391	320,372	362,848	402,084
Total	191,272	292,163	346,145	383,717	422,724

Source: *APRA Points of Presence Survey, RBA Bulletin and APCA Payment Statistics*

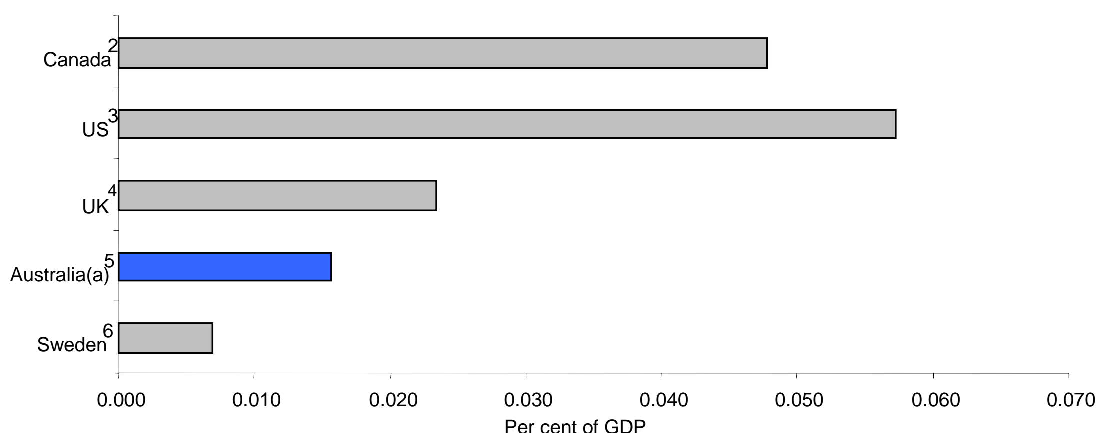
The trends in the delivery of financial services in Australia reflect the broad trends worldwide.

Reduced costs of regulation

Evidence compiled by the Wallis Inquiry indicated that the direct cost of regulation in Australia was relatively high compared to a sample of other jurisdictions. In part, these higher costs were attributed to new regulation introduced following the Campbell Report. Much of this regulation did not fully anticipate the pace of developments in financial markets.

More recent data on the direct costs of regulation indicate that costs in Australia relative to other selected countries have fallen (see Chart 4). The improvement in the direct cost of regulation likely reflects the streamlining of regulatory arrangements following the Wallis Inquiry. The reforms made following Wallis were designed to ensure that the regulatory framework was coherent, duplication was minimised, and unnecessary imposts were eliminated.

Chart 4: International comparison of total direct costs of financial sector regulation (per cent of GDP)[1]



1 Financial sector regulation refers to both prudential regulation and regulation of markets and securities. Country totals are not directly comparable because they have not been adjusted for differences in countries' financial industries, regulatory legislation and labour and other costs. They are also affected by relative strengths of countries' currencies against the sterling on the dates chosen for translation of local currency data into sterling.
2 The main costs of regulation in Canada come from the Office of Superintendent of Financial Institutions, Canadian Deposit Insurance Corporation, provincial regulators, the Canadian Investor Protection Fund and provincial insurance regulators.
3 The main costs of regulation in the US come from the Federal Reserve, regional reserve banks, The Federal Deposit Insurance Corporation, Office of Comptroller of the Currency, Treasury, state banking departments, Office of Thrift Supervision. Securities and Exchange Commission, Commodity Futures Trading Commission, self regulating institutions, state commissioners and the Department of Commerce.
4 The main costs of regulation in the UK come from the FSA and the Financial Services Ombudsman Scheme and the Financial Services Compensation Scheme.
5 The main costs of regulation in Australia come from APRA, ASIC and the PSB.
6 The main costs of regulation in Sweden come from the Finansinspektionen.
Source: (a) 2001-02 Total cost (from Measure 1) of APRA, ASIC and PSB. Other data from FSA 2000-01 Annual Report and OECD Main Economic Indicators.

Output benefits

While it is difficult to identify separately benefits of individual reforms, the integration of Australia into the global economy coincided with strong improvements in productivity and income growth, both relative to historical growth and to the OECD average.

The Australian economy strengthened considerably in the 1990s with nine years of persistent growth. This strong performance included thirteen consecutive quarters of through the year growth above 4 per cent ∝ the longest run of such growth recorded in the history of the quarterly National Accounts (since September 1956).

Table 2: Average annual growth rates, 1970-2000: % change

	GDP growth				GDP growth per capita			
	1970-1980	1980-1990	1990-2000	1996-2000	1970-1980	1980-1990	1990-2000	1996-2000
Australia	3.2	3.2	3.5	4.2	1.5	1.7	2.3	3.0
OECD[1]	3.4	3.0	2.5	3.2	2.5	2.3	1.8	2.6

1. Weighted average
Source: OECD 'The sources of economic growth in OECD countries', 2003

Productivity performance

During the 1990s, productivity growth rates in Australia returned to levels not seen since the late 1960s. By the second half of the 1990s, Australia's average annual labour productivity growth was more than double that recorded in the late 1980s and exceeded the OECD average.

Similarly, Australia experienced strong growth in multi-factor productivity (MFP). The strong growth in MFP in the 1990s highlights the fact that Australia's productivity surge reflected underlying improvements in the overall efficiency of the economy. This reflects factors such as improving management and work practices within industries, and resource allocation into more productive industries.

Table 3: Productivity growth rates in Australia (annual average)

	Labour	Multifactor
Second half of the 1990s	3.7	2.0
1990s	2.9	1.4
1980s	1.4	0.4
1970s	2.8	1.3
Long term average (since 1964/65)	2.4	1.1

Source: The Australian Bureau of Statistics, Catalogue Number 5204.0.

Australia's strong productivity growth was a payoff from sustained macroeconomic and structural reforms. Indeed, the OECD, in its 2003 Economic Survey of Australia, noted that 'dogged pursuit of structural reforms across a broad front, and prudent macroeconomic

policies set in a medium-term framework, have combined to make Australia one of the best performers in the OECD, and also one notably resilient to shocks, both internal and external'.

Recent Australian and US analysis, and new multi-country comparisons, have helped to further identify the reasons for this strong performance (Treasury 2003). In short, deregulation and strong competition drove new work practices and encouraged rapid uptake of business-transforming information and communication technologies in a macroeconomic environment that supported steady growth and strong investment.

The cross-country evidence also shows that a sophisticated, effectively regulated financial sector is an important contributor to growth. As the OECD notes, 'there is growing evidence that a well developed financial system is an important aspect of a favourable environment for growth, especially in a period of the rapid spread of a new technology when they can promote new, innovative enterprises (OECD 2003). The Australian experience with financial sector liberalisation, underpinned by stable and supportive macroeconomic policies and structural reforms, contributed to sustained economic growth and reduced Australia's susceptibility to economic shocks.

3. Lessons

Design of financial regulation framework

In evaluating the regulatory framework, a number of factors have been identified that influence the effectiveness of financial sector regulation and subsequent changes to regulation. In particular, Australia's experience suggests that:

- the effectiveness of the financial regulation framework is enhanced if the objectives of regulation are clearly defined and the framework can adjust to developments in the financial sector;
- a balance needs to be struck when determining the appropriate level of regulation and transparency, between achieving stability and security and the promotion of competition, innovation and efficiency;
  - this includes the need for the reporting requirements of financial institutions and the regulations governing the behaviour of the supervisory authorities to be consistent with the requirements of the relevant international standards and codes, to ensure international competitiveness and best practice;
- benefits of reforms to financial regulation may take some time to be realised and may require complementary reforms in many different areas and/or sectors; and
- once a reform process has begun, it gains its own momentum, and it is important that governments maintain an on-going commitment to reform, including periodic reviews,

which look at the operation of the financial system holistically so that the effects of *ad hoc* or piecemeal efforts can be assessed and revised as necessary to ensure complementarity.

The process of reforming the structure of financial regulation in Australia has highlighted the importance of ensuring that the objectives of regulation are clearly defined and the regulatory framework is sufficiently flexible to adjust to developments in the structure of the financial sector over time.

The recognition of the complexity and special nature of financial markets has led to the establishment of specialised regulatory arrangements for the financial sector in most countries. However, it is also important to recognise that the imposition of regulation on financial markets may restrict the ability of financial sector participants to operate efficiently, and potentially impede competitive pressures and innovation. Therefore, in designing financial regulation, a balance needs to be struck between achieving stability and integrity in the financial system and promoting financial markets that are competitive, efficient and innovative.

This trade-off between stability and efficiency, and its implications, has been highlighted by developments in financial regulation in Australia. The financial regulation framework in place up to the early 1980s relied heavily on the restriction of market forces to maintain financial market stability and security. While this approach was successful in maintaining stability, it also resulted in impediments to competition, reduced efficiencies (both in the market itself and the broader economy) and resulted in a lack of responsiveness to consumers ∝ in short, it inhibited growth.

The changes subsequently made to financial regulation have shifted the focus from restricting market forces to less interventionist mechanisms ∝ such as prudential standards and disclosure requirements. These changes assisted to increase competitive pressures by reducing barriers to entry and enhancing competitive neutrality between different entities providing similar services.

The degree of regulation has also been adjusted in recognition of the level of risk of market failure. For example, prudential regulation powers are strongest for deposit-taking institutions and less interventionist for investment products. The improvements in efficiency and innovation that have flowed from the regulatory changes introduced since the early 1980's have demonstrated the potential benefits of achieving a more appropriate balance between competition and stability.

The experience in Australia with financial regulation also highlights the importance of the regulatory framework being sufficiently flexible to accommodate developments in the structure of the financial sector and ensuring that any necessary regulatory response is systematic and complete.

Over the course of the 1980s and early 1990s the financial regulation framework required numerous adjustments to respond to innovations in financial services and the way these

services were delivered. In particular, regulation was predominantly based on the institutional form of the service provider and the traditional distinctions between markets and products. However, this approach did not adequately accommodate the increasing incidence of financial service conglomerates. The Wallis Inquiry found that while governments and agencies had identified trends in the evolving financial system, the regulatory response was often ad hoc and uncoordinated. This led to regulation arrangements that in some cases were inconsistent, resulted in regulatory gaps and was not conducive to effective competition in financial markets.

The shift in the basis of financial regulation from the institutional form of the service provider to a functional-based approach following the Wallis Inquiry has improved the flexibility of the regulatory framework. It has provided for a more coherent and streamlined approach to regulating financial service providers, including conglomerates. This has been reflected in improvements in the relative costs of regulation in Australia.

Financial stability lessons

Many of the financial stresses brought about by globalisation impact directly or indirectly on the financial system. Typically, currency mismatch problems, such as those discussed in Section 1, impact directly on the soundness of banks since the banking system frequently intermediates between foreign currency lenders and domestic firms. If hedging instruments are not available, the banking system either suffers directly through taking on the foreign currency risk itself or indirectly through the default of domestic firms that have borrowed from it in foreign currency. Maturity mismatches can also create severe liquidity problems for financial institutions. In addition, high levels of capital inflow or domestic credit growth following liberalisation often result in boom-bust cycles in asset prices, which once again put pressure on financial institutions via declining credit quality and the reduced value of collateral.

A precondition for weathering these stresses successfully is for the banking system to be well managed, well capitalised and well supervised. As discussed in Section 1, deregulation in Australia created pressures on the Australian financial system and highlighted weaknesses in bank management and prudential supervision which have subsequently been addressed.

Although the disruption to the banking system experienced in Australia was in many ways similar to that experienced in many countries opening up to foreign capital, and the institutional setting at the time was heavily influenced by the pressures of opening up markets, the specific pressures were largely driven by the freeing up of domestic credit. Nonetheless the implications for financial supervision are the same. This illustrates an important point ∝ that sound institutions are necessary irrespective of globalisation, although globalisation may increase the costs of not having them.

While some areas in the Australia economy were not fully prepared for financial liberalisation – such as in the general understanding of foreign exchange risks – the economy was able to

absorb the transition. This suggests that by the early 1980s, the economy had reached some critical thresholds.

We would argue that the most important thresholds were:

- the ability to manage currency mismatch, as Australian entities were able to borrow in domestic currency, both through domestic markets and offshore; and

- a sufficient soundness of the banking sector, which was therefore able to absorb the losses which arose at the end of the post-liberalisation boom in asset prices.

There is a difficult trade-off between institutional development and financial liberalisation. Liberalising before institutions are sufficiently sound can make the benefits from liberalisation ambiguous. On the other hand, liberalisation can hasten institutional development, for instance by knowledge transfer from foreign financial institutions participating in the local market.

These developments suggest that, even in relatively well-developed and deep markets like in Australia, currency volatility raises some important management issues for corporations. Such volatility may be more pronounced in less developed and less liquid markets.

- there are a variety of factors that could assist in smoothing the transition to a liberalised financial sector, the most important being the ability to borrow in domestic currency and the soundness of the banking system. Australia seemed to have reached or passed the thresholds in these areas by the early 1980s.

Broader policy lessons

The Australian experience has also demonstrated that reforms are inter-related. For example, the deregulation of the financial sector contributed to pressures to re-think the conduct of monetary and fiscal policy. It also placed pressures on other areas of regulation. This suggests the desirability of broad based reform which takes account of synergies between different policies at an early stage.

That said, there is no exact blueprint for reform and, politically, there are limits to the amount of reform that can be implemented at any one time. Governments must take opportunities as they arise as they can only realistically champion a small number of causes. Moreover, in the absence of perfect foresight, reform will always necessarily be an iterative process.

There are, however, some general considerations that can be drawn from the Australian experience. In particular, the following observations can be made:

- adjustment costs may have been lower had prudential reform occurred at the same time as restrictions on competition were removed;

- reforms to the financial sector, in conjunction with the removal of controls on capital flows and exchange rates, can have significant effects on the conduct of fiscal and

monetary policy. In Australia, these changes helped bring about pressure for an independent monetary policy and a medium term fiscal policy that reflected the impact of the budget on national saving; and

- reforms to one area of regulation have flow on effects to other areas of regulation. In Australia's case, financial sector reforms added to pressure for changes to other areas of regulation, such as competition policy, corporate law and taxation law.

4. Going forward

Australia has sought to develop a regulatory framework that is sufficiently flexible to remain robust in the face of future changes in the global environment. However, in recent decades the financial sector has been one of the most vibrant sectors in the Australian economy and this can reasonably be expected to continue over the foreseeable future. The structure and operation of the financial sector will continue to evolve as globalisation, financial convergence and the introduction of new technologies alters the business environment. This suggests that the regulation of the financial sector will continue to be a dynamic task.

The agenda for financial sector regulation in Australia can be split into two broad groups. First, a number of the recent financial regulation reform packages are currently being implemented and this process is likely to require, in some cases, up to several years. Second, there are likely to be several specific regulatory issues that will need to be assessed over the course of the next few years. Specifically, future challenges going forward include:

- continued implementation of reforms in the areas of financial services reform, general insurance (which are expected to be fully implemented by 1 July 2004), corporate governance, compliance with the recommendations of the Basel Committee on Banking Supervision (expected to be complete by 2007), and measures for improving the safety of superannuation;

- review of the regulation of conglomerates – the development of complex company structures, including intra-group transactions and cross-guarantees, has demonstrated that supervision would in some cases be more appropriately conducted on a group basis. APRA has undertaken work to develop a framework for the prudential supervision of conglomerates that included an authorised deposit-taking institution;

- ongoing monitoring of the structure of financial regulation to ensure that it remains efficient and effective in the face of a changing global environment;

- the consideration of possible approaches to increase policyholder protection – the failure of HIH Insurance Group generated renewed discussion on the merits of establishing systematic arrangements to protect the interests of policyholders when an institution fails; and

- seeking greater international cooperation on financial sector regulatory issues. Regulation of financial services has been responding to the implications of globalisation through improved communication and coordination between financial regulators across different countries. The benefits of these closer relationships between regulators is likely to increase as the provision of financial services becomes increasingly internationalised.

Attachment: Chronology of major measures and reforms associated with the deregulation of Australia's financial sector

Year	Measures/reforms
1960	Reserve Bank begins operations
	Sydney Futures market begins operations
1962	Three-month Treasury notes replace seasonal securities
	Savings banks allowed to make some personal loans
1965	Authorised money market dealers allowed to trade in commercial bills (previously only in government paper)
	Guidelines set to limit borrowing in Australia by overseas companies
	Trading banks offer unsecured personal loans
1966	Qualitative guidelines for bank lending (specifying categories of borrowers) cease
1967	Trading banks allowed to make secured personal loans, short-term mortgage loans and bridging loans
	Six-month Treasury notes issued
1968	Trading banks allowed to enter lease finance
1969	Trading banks allowed to issue certificates of deposit (CDs), but with constraints on rates and maturities
1971	Trading banks allowed to deal as principals in foreign exchange transactions with the Reserve Bank (previously banks acted as agents)
	Surveillance by Reserve Bank of capital inflows
1972	Embargo on foreign borrowings of less than two years. Constraints on overseas borrowings in Australia lifted. VDRs (variable deposit requirements) introduced requiring a non-interest bearing deposit equal to one quarter of foreign borrowing to be lodged with the Reserve Bank
1973	Controls on capital inflows further increased. VDRs increased to one-third
	Ceiling interest rate on CDs abolished
1974	Credit squeeze (later conceded to have been more severe than planned). CD rates rose above 20 per cent as the banks sought to improve their liquidity by liability management
	VDRs successively lowered and then dropped; and restrictions on foreign inflows relaxed
	Select Committee on Securities and Exchange report on the securities industry
	Financial Corporations Act became operative
	First Australian credit card (Bankcard)
1976	Australian Savings Bond (ASBs) replace Special Bonds. First issue heavily subscribed
	Monetary target introduced
	$A devalued; 'flexible peg' exchange rate system adopted.
	Australians permitted to trade in gold
1977	Restoration of restraints on capital inflows, VDR restored and set at one-quarter, later removed
1978	Further relaxation of constraints on foreign borrowing and investment
1979	Campbell Committee established
	Bank of Adelaide in difficulties because of property dealings of its subsidiary
	National Companies and Securities Commission established

Chronology of major measures and reforms associated with the deregulation of Australia's financial sector (cont.)

Year	Measures/reforms
1979 (cont.)	Interest rates futures traded and banks enter hedge market
	Treasury notes sold by tender
1980	Relaxation of controls on foreign portfolio investments
	Treasury bonds sales on tap instead of by periodic issues
	Banks permitted to have 60 per cent share in merchant banks (previously 30 per cent)
	Ceilings lifted on bank deposit rates but controls on maturities remain
	First cash management trust established
1981	Australian Bank established (first new bank licensed for mote than half a century)
	Mergers of private banks reduce their number by two
	Maturity controls on CDs eased to allow issues of thirty days (down from three months)
	Final Report of Campbell Committee
	Savings banks introduce card accounts (previously passbook)
1982	Trading and savings banks given more freedom in liability management. End of quantitative controls on bank lending
	Savings banks' portfolio constraints eased
	Variable repayment home loans.
	Visa card introduced
	Tender system for Treasury bonds
1983	Announcement that new banks would be licensed
	Dollar floated
	Martin review group appointed by new government to assess Campbell Report
	Mastercard introduced
1984	Martin review group endorsed Campbell Report
	Stock exchanges deregulated
	NBFIs allowed to become licensed foreign exchange dealers. Controls on banks' deposit rates and maturities lifted
	Savings banks allowed to offer cheque accounts
	Interest paid on cheque accounts for first time this century
	Controls on foreign and domestic bank holdings of equity in merchant banks eased (later lifted)
	Applications for new banking licences invited in line with Campbell recommendations
1985	Monetary targets abolished
	Controls on bank lending rates lifted except for home mortgages. Reserve Bank commences process of developing prudential supervision
1985-88	Expansion of tax Base and tax reforms Including capital gains tax and fringe benefit tax, dividend imputation, superannuation, but not including a broad-based consumption tax
1986	Announcement that statutory reserve deposits (SRDs) are to be phased out
	Reserve asset ratio for savings banks reduced
	Home mortgage rates of banks deregulated except for existing loans
	Cheques and Payments Order Act allows non-bank financial institutions to issue payment orders

Chronology of major measures and reforms associated with the deregulation of Australia's financial sector (cont.)

Year	Measures/reforms
1987	Reserve asset ratio of savings banks reduced to 13 per cent
	Australian Stock Exchange commences operations
	Insurance and Superannuation Commission established
1988	End of SRDs. Prime asset ratio (PAR) reduced to 10 per cent. Savings banks subject to same PAR system
	Reserve Bank defines risk-weighted capital adequacy guidelines for banks
	Series of major collapses of financial enterprises and leveraged corporations
	Last issue of Australian Savings Bonds
	Government's tariff reduction program begins
	Commonwealth Industrial Relations Act
1989	Amendments to Banking Act eliminates distinction between trading and savings banks and empowers Reserve Bank's prudential supervision
1990	PAR reduced to 6 per cent
	New solvency requirements for general insurers announced. Restrictions on borrowings in Australia by foreign governments lifted. 12 month freeze on withdrawals from unlisted property trusts
	Australian Securities Commission replaces National Companies and Securities Commission, formation of Australian Financial Institutions Commission announced
	Martin Committee Report into Banking and Regulation
1991-2002	Privatisation of government business enterprises: Commonwealth Bank 1991; 1993; 1996. QANTAS 1992; 1995; Federal Airports 1997-98; Telstra 1997; 1999; National Rail Corporation and NSW Freightcorp 2002; Sydney Airport 2002
1991-92	Telecommunications monopoly ended, full competition not introduced into sector until 1997
1992	Amendments to prudential standards for insurance companies
	Reform of corporations law relating to directors' duties and disclosure
	Formation of council of Financial Supervisors to co-ordinate the activities of the major supervisory authorities; members comprise Reserve Bank (Chair), the Insurance and Superannuation Commission, the Australian Securities Commission, and the Australian Financial Institutions Commission
	Industrial Relations Act 1988 amended to permit enterprise bargaining
1992-2002	Superannuation Guarantee Charge Introduced a system of universal minimum rate of employer superannuation contributions. The contribution rate increased from 3 per cent in 1992-93 to 9 per cent in 2002-03
1993	Federal legislation facilitates establishment of branches of foreign banks
	Superannuation Industry Supervision legislation increases prudential super superannuation industry
	Industrial Relations Reform Act 1993 enacted, providing for both union and non-union agreements
1994	State and Federal governments establish a taskforce to promote a national prudential supervision for friendly societies
	Reserve Bank announces that mortgage loans will attract the 50 per cent risk weighting ∝ where the loan to valuation ratio is less man 80 per cent

Chronology of major measures and reforms associated with the deregulation of Australia's financial sector (cont.)

Year	Measures/reforms
1994 (cont.)	New guidelines announced about the composition of bank boards and the role of bank subsidiaries as trustees for superannuation funds
1995	Sale of State Bank of NSW to the insurer, Colonial Mutual
	Life Insurance Act *1995* comes into force
	National Competition Policy, implementation occurred in 1996 and is ongoing
1996	Wallis Inquiry into Australian financial system begins
	Inflation target agreement with RBA
1997	Government announcement that tariffs on passenger motor vehicles (PMV) would fall until 2000, and would remain at that level until 2005 when there would be a further reduction to 10 per cent
	Similarly, tariffs on textiles, clothing and footwear (TCF) would continue to fall until 2000, remaining at their 2000 levels of 10, 15 and 25 per cent until 2005. From 2005, items at 25 per cent will fall to 17.5 per cent, those at 15 per cent to 10 per cent, and those at 10 per cent to 7.5 per cent.
	Workplace Relations Act 1996 proclaimed, allowing formalised individual and collective (union and non-union) agreements
	Opening of telecommunications sector to full competition and the introduction of telecommunications-specific competition regulation
	National Gas Access Code Agreement
1997 to date	Corporate Law Economic Reform Program (CLERP) including the *Financial Services Reform Act 2001* to improve Australian corporate governance standards and introduced a harmonised licensing, conduct and disclosure regime for providers of financial services
1998	*Charter of Budget Honesty Act*
	Creation of national electricity market
	Waterfront reform to improve performance
1999	The New Business Tax System reduces the company tax rate from 36 per cent to 30 per cent from 2001-02 and introduces an internationally competitive capital gains tax regime and a simplified tax system for small business
2000	The New Tax System introduces the goods and services tax (GST)
2001	Intergenerational Report opens community debate on medium-term demographic and fiscal issues
2002	Government announces that PMV tariffs would fall from 10 per cent to 5 per cent in 2010
	The Productivity Commission is currently conducting an inquiry into post-2005 assistance arrangements for the TCF industry with a final report to Government due on 31 July 2003

Source: The Commonwealth Treasury and 'The Australian Financial System: evolution, policy and practice', MK Lewis and RH Wallice.

BIBLIOGRAPHY

Australian Bureau of Statistics, Catalogue Number 5204.0.

Costello, P. (1997), 'Reform of the Australian Financial System' statement by the Treasurer, the Hon Peter Costello, MP, House of Representatives, 2 September 1997.

Comely, B, Anthony, S, and Ferguson B. (2002), 'The effectiveness of fiscal policy in Australia ∝ selected issues', in The impact of fiscal policy, Bank of Italy Research Department Fiscal Policy Workshop, Essays presented at the Bank of Italy workshop 21-23 March 2002.

Gizycki, M. and Lowe, P. (2000), 'The Australian Financial System in the 1990s', in The Australian Economy in the 1990s, Gruen, D. and Shresta, S. (Eds), Reserve Bank of Australia.

Gollan, R. (1968), The Commonwealth Bank of Australia: Origins and Early History, Australian National University Press Canberra.

Kenwood, A. (1995), Australian Economic Institutions Since Federation: An Introduction, Oxford University Press.

KPMG Financial Institutions Performance Survey 1995, 1996 and 2002.

Lewis M. K. and Wallace R. H. (1997), The Australian Financial System: Evolution, Policy and Practice, Addison Wesley Longman.

OECD (2000), Economic Survey of Australia, http://www.oecd.org.

OECD (2003), The Sources of Economic Growth in OECD Countries.

Peat Marwick Mitchell and Co (1985), Banking in Australia.

Reserve Bank of Australia (2002), 'Innovations in the Provision of Investor Finance', Reserve Bank Bulletin, December 2002.

Reserve Bank of Australia (2003), 'Banking Fees in Australia', Reserve Bank Bulletin, April 2003.

The Treasury (1999), Making Transparency Transparent: An Australian Assessment, Commonwealth of Australia.

The Treasury (2001), Budget Strategy and Outlook 2001-02: Budget Paper No. 1, Commonwealth of Australia.

The Treasury (2003), Budget Strategy and Outlook 2003-04: Budget Paper No. 1, Commonwealth of Australia.

Valentine (1991),'What the Campbell Committee Expected', The Deregulation of Financial Intermedaries, Macfarlane (Ed) 1991.