FINANCIAL DEREGULATION:
FACT AND FANTASY

by

W.P. Hogan

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FINANCIAL DEREGULATION: FACT AND FANTASY

1. Introduction

The most visible manifestation of deregulation of the financial services sector in Australia was the entry of many new banks from 1984-85 onwards. Whether or not such entry was the most important feature of the shift in the strategy for regulation of banking and financial markets in Australia during the 'eighties is a question central to the main themes of this paper, namely the experience of financial deregulation and its outcomes.

An understanding of what has come to be referred to as deregulation of financial markets is best grasped in the context of the application and adaptation of regulations in earlier decades. With this perspective the emphasis is on policy development rather than the experiences and effects of specific measures. Where reference is made to specific outcomes this will be illustrative more than comprehensive in its purpose.

The term "regulation" implies legislative and administrative arrangements whereby the activities of market participants are subject to the direction of and scrutiny by various authorities, the most notable of which is the Reserve Bank of Australia (RBA) in its role as supervisor of the banking system with broad powers conferred by the Banking Act and the Reserve Bank Act. The "regulation" referred to is the power to specify both the qualitative aspects of business conducted by a bank and the quantitative features of the asset portfolio. This means the administrative determination of prices charged for financial services and the types of service offered. For example, the interest rates payable on deposit liabilities and the minimum maturities of deposits on which interest could be paid as well as limits on the interest rates to be charged on bank advances (loans). It also meant directions on the type and quantity of new loans.

The term "deregulation" should be interpreted strictly in the context of the environment fostered by regulation of the qualitative and quantitative aspects of banking and financial activities. Deregulation in the present Australian context, as in others, has the limited meaning of the removal of restrictions on the quantity, quality and pricing of financial services, most of all those offered by banks.

Deregulation cannot refer to the removal of all legal and administrative requirements about the conduct of the business of banking or any other financial intermediary. Banking and financial activities rest upon a large body of legislation and judicial decisions to permit the completion of massive numbers of financial transactions each day. The efficiency of financial markets depends in part on the existence of a comprehensive and stable set of laws and procedures to allow parties to financial transactions a known basis for completion of their contracts. The integration of national financial markets, increasingly so during the past decade, has brought to prominence the necessity for international agreements on the means for financial settlements even though the common practices are usually those of one or other of the major financial centres. Similarly the development of international agreements and understandings on the organisation and supervision of banking and securities markets has been hastened by this integration.

Monetary authorities have responsibility for the stability of the banking and financial system. Quite apart from the regulatory themes spelt out in preceding paragraphs, these authorities seek to avoid conduct by any one or set of financial intermediaries which risks undermining confidence in the integrity and stability of the financial system in general. They have fostered the application of prudential regulation whereby banks have been constrained in their management of portfolios of assets and liabilities so as to moderate insolvency risks and thwart system instability.

Evidence of incipient system problems emerged during 1990 in Victoria, as a result of failures amongst intermediaries not subject directly to the scrutiny of federal authorities, requiring public statements from the RBA and the setting in place of liquidity support from major banks. This was a repetition, though of greater dimensions, of experiences in 1974 when financial illiquidity saw failures amongst intermediaries associated with property development and special measures by the RBA to alleviate strains in the financial services sector. Circumstances leading to the absorption of the Bank of Adelaide by the Australia and New Zealand Bank (ANZ) during 1979 had their genesis in this experience.

This type of regulation is not directed to the pricing of liabilities or assets though it bears upon structure in so far as minimum requirements for capital-assets ratios and maximum percentages for assets to be allocated to any one corporate group may be specified. However, the purpose is not to control the range of business undertaken by banks and the terms and conditions of individual transactions. Nevertheless some aspects of prudential regulation may distort the conduct of banking business should they induce greater risk-taking than would have been the case in the absence of some particular prudential requirement. For example, the risk-weighted capital adequacy requirements for banks do not distinguish between shorter term funding of companies
with strong financial standing and other commercial borrowers of lesser standing. The effect is to encourage lending with higher returns. Possibilities for this type of distortion are not uncommon. (13, pp. 185-189)

Most attention in this appraisal is given to banking owing to the dominance of banking matters in public controversies over deregulation. Moreover many of the changes in other parts of the financial sector were repercussions of decisions taken about banking. Nevertheless many changes were happening in other parts of the financial services sector, most notably in securities markets and that part of funds management bearing upon insurance and superannuation. The next section reviews changes in the structure of the financial services sector during the postwar era. Its purpose is to offer a broad guide to the alterations in the relative use of different types of financial intermediation over four decades. The third section examines the ways in which regulation has changed in the Australian financial scene over the past half century. The fourth section examines the influence and significance of a particular set of conditions - ownership and entry - for competition in the financial services sector. The fifth section analyses some issues basic to the shifts in strategy towards a less regulated financial services sector. The final section is a summary of the issues in deregulation having as its purpose distinguishing between the facts and the fantasies of the experience.


The value of assets held by all Australian financial institutions and the percentage of each category of these institutions in total assets are shown in Tables 1 and 2. These are for one year in each of the past four decades - 1956, 1966, 1976, 1986 - and 1971 because of its significance as the turning-point in postwar international economic arrangements. This data should be treated as indicative rather than precise because of problems of consistency in its collection.

An effective benchmark year following the period of economic adjustment after World War II and then the commodity boom associated with the Korean war and reaction to it, is 1956. The data on values in Table 1 and market shares in Table 2 show the dominance of the banking system and insurance groups amongst financial institutions. Between them they held over 86 per cent of all the assets of financial institutions. Notable was the relative size of the central bank to the other institutions.

Shifts in its assets and liabilities portfolio could impinge severely upon the assets of the rest of the financial services sector. Thus the monetary authorities had at that time a huge leverage over the assets and liabilities of the rest of the financial system.

In the 'fifties there remained a plethora of controls over financial activity. Qualitative and quantitative directives laid down the activities to be undertaken by banks in their liabilities and assets creating functions. Exchange controls restricted the flow of funds between Australia and the rest of the world with the effect of limiting the holding of foreign assets by Australian residents, individuals and corporate entities, while mobilising foreign exchange holdings with the central bank and leaving only working balances with the then trading banks.

The effect of these regulatory provisions was to restrict access to credit facilities. This era of credit rationing meant that the pricing of financial services did not reflect market conditions but rather administrative determination.

The data for 1966 brings out the adjustments taking place as market participants sought alternative sources of funds and avenues for the placement of funds. The decade from 1956 to 1966 saw the rapid growth of finance companies which were not subject to control by monetary authorities. Their asset portfolios quadrupled in size and nearly doubled in market share, an expansion to be repeated in the next decade. The finance companies took advantage of the unsatisfied demand for credit arising from the restrictions on what business the banks could undertake and the prices they could charge. They found ready markets for consumer credit financing in retail markets and related financing in the wholesale markets, most of all with motor vehicles and dealers.

Finance companies could charge what their borrowers were prepared to pay. To fund that asset creation they could offer higher rates to depositors and subscribers to debenture issues than banks were permitted to do. In this way households and, to a much less extent, companies were able to secure higher earnings on their financial assets.

No less revealing was the role of life and superannuation funds. Their growth reflected much the same interests as associated with deposit-taking activities of finance companies. However, tax influences bore heavily on this expansion as contractual superannuation payments by individuals were deductible from income before determining income tax payable. These funds did not have the same flexibility as finance companies in their asset activities as they were required to hold part of their portfolios in government securities.

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1. According to the Concise Oxford Dictionary a fact is an item of verified information, a thing known to have occurred. A fantasy is a fanciful mental image, the faculty of inventing images, especially extravagant or visionary ones.

2. At this time the central banking functions were pursued within the Commonwealth Bank. Only in 1959 was a separate central bank, the Reserve Bank of Australia, created under its own Act.

3. The distinction between trading and savings banks was eliminated in December 1989.
### Table 1: Total Assets of Financial Institutions, 1956 to 1986
(at 30 June each year shown)

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Reserve Bank</td>
<td>1828</td>
<td>2336</td>
<td>3661</td>
<td>6193</td>
<td>24042</td>
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<tr>
<td>2. Other Banks**</td>
<td>5659</td>
<td>11471</td>
<td>16940</td>
<td>37096</td>
<td>156223</td>
</tr>
<tr>
<td>(a) Trading</td>
<td>3301</td>
<td>5979</td>
<td>8978</td>
<td>21788</td>
<td>108514*</td>
</tr>
<tr>
<td>(b) Savings</td>
<td>2398</td>
<td>5547</td>
<td>8074</td>
<td>15568</td>
<td>47942*</td>
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<tr>
<td>(c) Other</td>
<td>73</td>
<td>192</td>
<td>581</td>
<td>1144</td>
<td>3650</td>
</tr>
<tr>
<td>3. Life &amp; Pension Funds</td>
<td>2107</td>
<td>3551</td>
<td>9763</td>
<td>16557</td>
<td>69121</td>
</tr>
<tr>
<td>(a) Life</td>
<td>1400</td>
<td>3621</td>
<td>6064</td>
<td>9703</td>
<td>32917</td>
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<tr>
<td>(b) Pension</td>
<td>707</td>
<td>2230</td>
<td>3699</td>
<td>6864</td>
<td>36204</td>
</tr>
<tr>
<td>4. Other Insurance</td>
<td>290</td>
<td>1166</td>
<td>2020</td>
<td>4390</td>
<td>18431</td>
</tr>
<tr>
<td>5. Finance Companies</td>
<td>431</td>
<td>1674</td>
<td>4104</td>
<td>10927</td>
<td>29573*</td>
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<tr>
<td>6. General Financiers</td>
<td>-</td>
<td>87</td>
<td>210</td>
<td>870</td>
<td>5327</td>
</tr>
<tr>
<td>7. Money Market Corporations</td>
<td>5</td>
<td>82</td>
<td>999</td>
<td>2980</td>
<td>31332*</td>
</tr>
<tr>
<td>8. Building Societies</td>
<td>329</td>
<td>1440</td>
<td>5092</td>
<td>20124*</td>
<td></td>
</tr>
<tr>
<td>9. Co-op Housing Societies</td>
<td>556</td>
<td>728</td>
<td>1014</td>
<td>1783</td>
<td></td>
</tr>
<tr>
<td>10. Authorised Money Market Dealers</td>
<td>-</td>
<td>413</td>
<td>773</td>
<td>1053</td>
<td>2046</td>
</tr>
<tr>
<td>11. Credit Co-operatives</td>
<td>3</td>
<td>42</td>
<td>171</td>
<td>839</td>
<td>6531</td>
</tr>
<tr>
<td>12. Pastoral Finance Cos.</td>
<td>297</td>
<td>511</td>
<td>651</td>
<td>710</td>
<td>5296</td>
</tr>
<tr>
<td>13. Intra-Group Financiers</td>
<td>-</td>
<td>24</td>
<td>36</td>
<td>343</td>
<td>4282</td>
</tr>
<tr>
<td>14. Cash Management Trusts</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>3302</td>
<td></td>
</tr>
<tr>
<td>15. Trusts: Equity, Property, etc.</td>
<td>48</td>
<td>232</td>
<td>266</td>
<td>438</td>
<td>10682</td>
</tr>
<tr>
<td>16. Other</td>
<td>29</td>
<td>232</td>
<td>662</td>
<td>1041</td>
<td>5173</td>
</tr>
<tr>
<td>Total</td>
<td>11024</td>
<td>25056</td>
<td>42424</td>
<td>89553</td>
<td>393268</td>
</tr>
</tbody>
</table>

### Table 2: Percentage Share of Total Assets of Financial Institutions, 1956 to 1986
(at 30 June each year shown)

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Reserve Bank</td>
<td>16.5</td>
<td>9.3</td>
<td>8.6</td>
<td>6.9</td>
<td>6.1</td>
</tr>
<tr>
<td>2. Other Banks**</td>
<td>51.0</td>
<td>45.8</td>
<td>39.9</td>
<td>41.4</td>
<td>39.7</td>
</tr>
<tr>
<td>(a) Trading</td>
<td>29.8</td>
<td>23.9</td>
<td>21.2</td>
<td>24.3</td>
<td>27.6</td>
</tr>
<tr>
<td>(b) Savings</td>
<td>21.6</td>
<td>22.1</td>
<td>19.0</td>
<td>17.4</td>
<td>12.2</td>
</tr>
<tr>
<td>(c) Other</td>
<td>0.7</td>
<td>0.8</td>
<td>1.4</td>
<td>1.3</td>
<td>0.9</td>
</tr>
<tr>
<td>3. Life &amp; Pension Funds</td>
<td>18.9</td>
<td>23.4</td>
<td>23.0</td>
<td>18.5</td>
<td>17.6</td>
</tr>
<tr>
<td>(a) Life</td>
<td>12.6</td>
<td>14.5</td>
<td>14.3</td>
<td>10.8</td>
<td>8.4</td>
</tr>
<tr>
<td>(b) Pension</td>
<td>6.3</td>
<td>8.9</td>
<td>8.7</td>
<td>7.7</td>
<td>9.2</td>
</tr>
<tr>
<td>4. Other Insurance</td>
<td>2.6</td>
<td>4.7</td>
<td>4.8</td>
<td>4.9</td>
<td>4.7</td>
</tr>
<tr>
<td>5. Finance Companies</td>
<td>3.9</td>
<td>6.7</td>
<td>9.7</td>
<td>12.2</td>
<td>7.5</td>
</tr>
<tr>
<td>6. General Financiers</td>
<td>-</td>
<td>0.3</td>
<td>0.5</td>
<td>1.0</td>
<td>1.3</td>
</tr>
<tr>
<td>7. Money Market Corporations</td>
<td>-</td>
<td>0.3</td>
<td>2.4</td>
<td>3.3</td>
<td>8.0</td>
</tr>
<tr>
<td>8. Building Societies</td>
<td>2.9</td>
<td>1.3</td>
<td>3.4</td>
<td>5.7</td>
<td>5.1</td>
</tr>
<tr>
<td>9. Co-op Housing Societies</td>
<td>-</td>
<td>2.2</td>
<td>1.7</td>
<td>1.1</td>
<td>0.5</td>
</tr>
<tr>
<td>10. Authorised Money Market Dealers</td>
<td>-</td>
<td>1.6</td>
<td>1.8</td>
<td>1.2</td>
<td>0.5</td>
</tr>
<tr>
<td>11. Credit Co-operatives</td>
<td>-</td>
<td>0.2</td>
<td>0.4</td>
<td>0.9</td>
<td>1.7</td>
</tr>
<tr>
<td>12. Pastoral Finance Cos.</td>
<td>2.7</td>
<td>2.0</td>
<td>1.5</td>
<td>0.8</td>
<td>1.3</td>
</tr>
<tr>
<td>13. Intra-Group Financiers</td>
<td>-</td>
<td>0.1</td>
<td>0.1</td>
<td>0.4</td>
<td>1.1</td>
</tr>
<tr>
<td>14. Cash Management Trusts</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>15. Trusts: Equity, Property, etc.</td>
<td>0.4</td>
<td>0.9</td>
<td>0.6</td>
<td>0.5</td>
<td>2.7</td>
</tr>
<tr>
<td>16. Other</td>
<td>0.9</td>
<td>1.1</td>
<td>1.5</td>
<td>1.2</td>
<td>1.3</td>
</tr>
<tr>
<td>Total</td>
<td>100.0</td>
<td>100.0</td>
<td>100.0</td>
<td>100.0</td>
<td>100.0</td>
</tr>
</tbody>
</table>

Note:* Categories influenced by shift into trading and savings banks of intermediaries previously recorded in the other three categories.  
** There are discrepancies partly reflecting timing but mainly arising from problems identifying interbank balances. The three categories exceed the total for all Other Banks.

Notes: Same as for Table 1
A much greater diversity emerged within the financial services sector between 1966 and 1976. Some long-established types of intermediary, especially the building societies, emulated the finance companies to become stronger in their market presence. As with the finance companies over the previous decade it was a reflection of an unsatisfied demand from households, in this case for access to residential mortgage finance. Others such as the money market corporations, more familiarly known as merchant banks, established positions in financial intermediation directed mainly to the wholesale market for business funding. The share of assets held by the banking system and insurance groups had fallen from 86 per cent in 1956 to about 67 per cent in 1976 though the authorised money market dealers, as adjuncts of the RBA, might be added to that estimate. It is well to remember that this shift is measured after the financial strains of the early 'seventies, to which reference has already been made, when there had been severe repercussions on some trusts and finance companies associated with overcommitments in land and property development.

The categories of financial activities displayed in Tables 1 and 2 record the relative shifts in contributions from different types of intermediation. In the twenty years from 1956 many activities were initiated to bring a much wider array of financing possibilities than hitherto. Nevertheless the ownership of the entities performing these different functions was much more integrated than this specification of functions might imply. Moreover this phenomenon was a response to as well as a reflection of regulatory practices laid down by the federal government and its agencies. The rapid growth in the role of finance companies from the 'fifties relative to that for banks' liabilities and assets led them to buy wholly or partly some finance companies. By 1976 most large finance companies were affiliated to or owned by the major banks or foreign banks not being authorised banks in Australia.

Where regulation of controls on the business of banking brought in its wake ownership of finance companies by banks, controls on foreign ownership of financial intermediaries in Australia brought the partnership of Australian financial intermediaries with many foreign participants in the ownership of the then new merchant banks. Controls on foreign participation brought a patchwork quilt of equity holdings amongst these financial intermediaries. But it is not as if merchant banks were treated differently from other activities whether in banking and finance or the production of goods and services. Controls on foreign ownership had been strengthened through the 'sixties while restraints on bank ownership generally limiting any holding to 10 per cent of equity were embodied in the Banks (Shareholdings) Act 1972.

Between 1976 and 1986 the most dramatic shifts in monetary, financial and banking policies for generations were witnessed. The banks and insurance groups still recorded some further loss in market share. The relatively large 'losers' were first and foremost the finance companies and also the building societies. The explanation for the drastic fall in the share held by the finance companies group is the removal of restrictions on the business conducted by banks and the entry of many new banks particularly during 1985 and 1986. As the finance companies' operations had largely been the creation of bank controls, the abandonment of those same controls during the first half of the 1980s meant some loss of their market purpose. Some building societies were the basis for new banks; the most prominent being the conversion of the NSW Permanent Building Society to the Advance Bank.

Major gains in market share accrued to the merchant banks with an increase of about 150 per cent, the credit unions, trusts and cash management trusts, and some specialised financing companies. With these developments the structure of relationships in the financial services sector had become even more diffuse than before where diversification had been a reflection of market segmentation induced by regulatory controls on the scale, structure and pricing of banking products. Realignments taking place between 1976 and 1986 were an initial reflection of the shift to a market-oriented environment, a process well under way but not transparent in the data for 1986, as well as the proliferation of many types of intermediary often providing services substitutable for those of banks. This examination of a changing structure over three decades points to shifts in relative size of different groups of intermediaries not all of which can be attributed readily to the market segmentation induced by the regulation of banking business. Hence techniques for policy implementation since World War II should be scrutinised if only to place in perspective the major changes in the middle 'eighties.

3. Regulatory Experience.

The arrangements devised at the Bretton Woods meetings in 1944 which led to the establishment of the International Monetary Fund(IMF) and the inauguration of a fixed exchange rate regime under its supervision provided the setting for monetary and financial policies generally. In practice this meant the alignment of currencies to the United States dollar which in turn was convertible into gold at a fixed price. While the free convertibility of all currencies was the goal of this system, the practice meant a widespread use of exchange controls especially on the movement of capital. Their purpose was the curtailment of changes in the holding of assets in foreign currencies so as to moderate pressures which could bring shifts in exchange rate relativities. Restriction was directed mainly to short-term movements of capital which had the potential for destabilising fixed parities between currencies.
a) Australian Regulation

In Australia this meant not only the application of exchange controls and the mobilisation of foreign exchange within the central banking function of the Commonwealth Bank, and from 1959 the RBA, but also the application of controls on the pricing of assets and liabilities, the type of lending to be undertaken and its quantity. These arrangements applied with little change through the 'fifties and 'sixties.' Monetary control was exercised by varying the Statutory Reserve Deposit (SRD) ratio which required each bank to hold a percentage of its Australian dollar deposits in a special account at the central bank. By varying the SRD ratio the monetary authorities changed the capacity of each bank to lend and thus add to or reduce its contribution to the money supply. For a long time this monetary device was supported by a convention, later a specific requirement, that a proportion of deposits be kept in liquid assets; the so-called LGS ratio which, by its abbreviation, indicates liquid assets, such as notes and coin, and holdings of government securities.

Separate rules applied to savings banks. Interest rate restrictions were the same as for trading banks. Asset management was determined fully. Deposits with savings banks had to be placed in government or government-guaranteed securities, federal or state, and loans on housing or loans secured by land apart from liquid assets held in notes and coin or in accounts at the central bank. Indeed 10 per cent of deposits had to be in liquid assets. More onerous was the prescribed assets ratio requiring 65 per cent of deposits' funds to be held in cash, deposits with the RBA and Commonwealth and State government securities issued or guaranteed by such governments.

Restrictions on banks' choices in asset management were matched by those influencing the behaviour of the insurance group in their life and pension funds activities. This group had been a major holder of government securities during World War II and the following decade. However, the widening choice amongst financial assets led to reductions in the proportion of government securities in their portfolios during the fifties. In 1961 the Federal Government required these funds to hold 30 per cent of their assets in government securities of which 20 per cent had to be those issued by the Commonwealth. This imposition was claimed officially to be anoffset for the tax concessions enjoyed by life and superannuation funds. The effect was to create a captive market for government securities to support a lower than market rate financing of government borrowings.4

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4 The policy impact of these provisions depends very much on the relative growth of life and pension funds' assets to the funding needs of government. As is evident from Tables 1 and 2 such assets were not growing as fast as total assets so that any increase in government borrowing requirements might only be met by competitive bidding in the uncontrolled segments of the capital market.

b) Adaptation

There was virtually no relaxation of rigorous control of price, quantity and quality of bank loans until the 'sixties. During 1965 the RBA relaxed steadily provisions as to whom banks could lend and the means by which liabilities could be funded. These steps reflected competition from finance companies, a phenomenon to which reference has already been made, when banks were given permission to provide lease financing outside maximum interest controls in May 1968, to issue certificates of deposit with maturities between three months and two years for over $50,000 and subject to maximum interest rates in March 1969, and then in December 1970 an increase in the term for fixed deposits from two to four years. During this period changes were made to the conditions imposed on savings bank deposits to give some flexibility in arrangements. Their prescribed assets ratio was reduced from 65 to 60 per cent in October 1970 and then 50 per cent in September 1974.

Much turmoil in banking and financial markets generally characterised the first half of the 'seventies. Domestic regulations were modified to give greater flexibility in conditions for creating liabilities and an opening up of short-term domestic financing of business. Most relaxation was directed to large deposits and large loans, generally those over $50,000; a reflection of the growing influence of the merchant banks. In contemporary parlance these shifts were being made in the wholesale market as business took advantage of greater diversity of funding sources to search other avenues than reliance on bank lending. The alternatives included borrowings in foreign capital markets though various restraints continued on such borrowings.

The expanding role of the merchant banks went beyond competitive pricing to the devising of more flexible arrangements for securing and restraining borrowers. Lending practices of banks were based up to this time upon securing a floating charge over the assets of the borrowing company or a fixed charge over its property. Both techniques restricted the capacity of borrowers to raise additional funds from other sources should the bank not wish to lend more against the specified security. In this situation the merchant banks had to devise measures which would protect their interests as far as possible despite prior claims of established lenders. The instrument applied was the negative pledge whereby the borrower agreed not to create any further encumbrance on assets which diminish the claims of the lender beyond those existing at the time the lending agreement was completed. Essentially the negative pledge is a prohibition, not a potential claim on assets. The effectiveness of the negative pledge
rests upon the probity of the borrower.5

The twin features - wider access to funding sources and greater flexibility in security terms for borrowings - changed irrevocably the basis for managing any one bank's assets. Whereas the long period of strict quantitative and qualitative controls had rendered asset management a relatively straightforward task these developments from the middle 'sixties had increased credit risk exposure. The severe economic conditions of 1974-75 were to reveal the consequences of these changes.

A most important shift in regulatory stance took place late in August 1973 when controls on the maximum interest rates on certificates of deposit issued by banks were removed. With this decision the banks were free to compete in wholesale funding markets other than the short-term sphere of three months or less. This greater flexibility in banks' management of liabilities went a substantial way to match the merchant banks which had switched their funding from equity and similar instruments to debt liabilities through the late 'sixties and early 'seventies. (32, p.72) As with asset management, this opening up of opportunities for banks to manage more effectively their liabilities reflected the heightened competition from the relatively newly resident merchant banks. Nevertheless the NBIFs retained their competitive advantages in the short-term money market as the authorities preserved the distinction between non-interest bearing demand deposits and term deposits bearing interest; a segmentation of markets not to be abandoned for almost another decade.

With foreign exchange markets one notable development came in August 1971 with the decision by the monetary authorities to allow banks to trade in foreign exchange rather than act only as agents for the Reserve Bank which had been their role for nearly three decades. The latter part of 1971 witnessed severe disturbance in foreign exchange markets with the suspension of convertibility of the U.S. dollar into gold during August and then the realignment of currency parities in December in what was the final effort to retain a fixed exchange rate regime. That same month saw the historical link of Australian currency to sterling abandoned and the tying of the exchange rate to the U.S. dollar. This was soon followed by the RBA bringing flexibility to its forward rate market for the Australian dollar, by quoting rates in terms of premium and discount though restrictions were retained on the total of forward cover available and those to whom this cover was applied. This step was designed to allow more prompt adjustment to market conditions in an international setting where exchanges seemed likely to be more volatile than in previous years. Perhaps more significantly the change helped curtail the RBA's exposure to loss on forward rate contracts.

Nonetheless the expectation remained that a fixed rate regime would persist as the basic feature of markets though official adjustments to relativities might be more frequent. This was confirmed publicly with the decision to impose quantitative restraints on foreign borrowings by Australian companies. A variable deposit requirement (VDR), initially set at 25 per cent, was imposed in December 1972. This designated proportion of the foreign loan had to be held on deposit at the RBA interest free until the loan matured. The aim was to eliminate short-term capital movements reflecting speculation on future changes in currency relativities. This was the period of the commodity boom with the exchange rate set at USD 1.4875 = AUD 1 in September 1973 and the VDR at 33.33 per cent in October.

c) Confusion of Strategies

In many respects the mid-'seventies represented the highwater mark for a regulatory stance towards the financial services sector despite the relaxation of some restraints in the immediate past years. The full flowering of this domestic phenomenon was embodied in the Financial Corporations Act 1974. The act provided for the registration and examination of the activities of all financial corporations in Australia and regulation of those activities. It was a response to the erosion in the relative significance of banks and insurance groups which in turn reflected regulation of their activities by monetary authorities and the absence of restraints on other financial intermediaries. Part IV of the Act conferred powers on the RBA to determine asset ratios for different types of financial corporations and their lending policies, and control their interest rates. All non-bank financial intermediaries (NBIFs) were to be subject to controls similar to those long exercised over banks.

In the event these provisions for controls on NBIFs were not proclaimed. This was in part a reflection of the time taken to implement the registration process under Part II of the Act. However, the change in the financial environment stemming from the abandonment of fixed price relativities in the international arena was very telling. The basis for international economic relationships had changed irrevocably so that the grounds for domestic policies in the previous decades had been swept away. Equally compelling was the prospect of a constitutional challenge to the validity of the legislation. Immediately more telling a reason for delaying implementation of the regulatory provisions in Part IV of the Act may have been the harsh conditions in 1974-75 which saw failures amongst some NBIFs and rescue of others by foreign participants.
Other major initiatives affecting the financial sector were contemplated by the then Federal Government. Most notable were proposals for a National Superannuation Fund which could have seen the frustration of the existing entities in their efforts to expand. Control of investment spending could then have been exercised by the managers and trustees of the proposed NSF through the allocation of funds.

Even with hindsight it still remains difficult to link the strategic purpose of these proposals with the practices emerging in the preceding few years. The easing of regulatory restraints on banks allowed more competition between them and many NBFIs, notably the finance companies and the merchant banks. To reverse this shift in focus would have required not just an extension of quantitative and pricing regulation but also stricter exercise of exchange controls over the ebb and flow of foreign funding, especially for the merchant banks.

Events in the international arena during 1973 and 1974 brought an end to any prospect of retaining the postwar fixed exchange rate system subject to officially-sanctioned adjustments. Major currencies were floating against the U.S. dollar and adjustments in currency relativities reflected massive structural disturbance arising from the sharp rise in the real price for crude oil coming towards the end of the long international commodity boom which had started in 1970. By September 1974 the value of the Australian dollar was linked to a trade-weighted basket of the major currencies of the countries with which Australia trades. At the end of that year the VDR was abolished.

d) Expanding Choices

From the middle of the 'seventies the range of financial markets and instruments available was extended. Credit cards were introduced with Bankcard, sponsored originally by the major banks jointly, the most successful. The Australian Savings Bond linked government funding requirements to households' savings and holdings of financial assets in 1976. In the same year an options market for equities was inaugurated. Late that year following a substantial devaluation of the Australian dollar by 17.5 per cent, the exchange rate was to be determined by a managed float allowing adjustments to be made to a trade-weighted calculation. The Sydney Futures Exchange (SFE) began trading gold futures in 1978 and currency futures the following year. Expansion of the commercial paper (promissory note) and the bill markets reflected the growing influence of merchant banks in shorter term money markets. Another important change came in December 1979 when the Federal government introduced a tender system for the sale of government securities so making funding sensitive to market rates of interest. Initially this applied only to short-term Treasury Notes but three years later was extended to all federal securities.

Expansion in the types of markets and instruments was not matched by relaxation of controls on banking activities. The latter part of the 'seventies saw the continuation of quantitative directions on the scale of lending not abandoned until early the following decade (26, p.9). However, this guidance was not confined to the banking system. Despite the failure to proclaim Part IV of the Financial Corporations Act 1974 the RBA in discussions with the major groups registered under that Act, "reminded them also that policy called for restraint in their lending ..." (25, p.14).

The influence most widely attributed in the public arena as signalling the opening up of the financial services sector from the long regulation phase was the Committee of Inquiry into the Australian Financial System, familiarly known as the Campbell Committee, which was commissioned on 18 January, 1979 (24). Even while the Campbell Committee was deliberating, new measures were taken to extend the scope of financial services and curtail further restraints on liabilities and asset management including the abolition of ceilings on interest rates offered on bank deposits. Interest rate futures contracts, using the bank bill, started trading on the SFE. A foreign exchange hedge market with settlement in Australian currency had been developed. The minimum term for certificates of deposit was reduced to one month. In February 1981 a new bank, The Australian Bank, was authorised to commence business.

However, well before that Committee reported its findings in September 1981, one financial innovation altered irrevocably the structure of the financial sector. That was the Cash Management Trust (CMT) introduced by Hill Samuel (now Macquarie Bank) in December 1980, it being the equivalent of money market mutual funds in the United States. The CMT joined together household and wholesale markets for funds by offering a highly liquid income-earning financial asset not matched by any other instrument in the then segmented financial markets in which banks were not allowed to offer interest on demand deposits or fixed term deposits of less than three months. Moreover the innovation was not independent of ambitions to secure new banking authorities in Australia. The CMT was treated by sponsoring merchant banks as a way to explore building a retail customer network should a banking authority be granted later. (33)

6 Commiss to be paid.
7 In 1981 the then new Australian Bank was prompt in combining a CMT with its deposit facilities so providing access to interest-bearing demand deposits. That bank commenced business in February 1981 and introduced its CMT in November the same year. This new bank devised a sweep technique whereby excess deposits as specified by their holders were placed at call in the house CMT.
e) Abandonment

Following the Campbell Report, further changes came swiftly. The minimum term on interest bearing deposits was cut to fourteen days for amounts greater than $50,000 and thirty days for lesser sums. For certificates of deposits the same fourteen days applied. Guidance by the RBA on the quantity of lending was abolished. Restrictions on savings banks' activities were relaxed; for example, the prescribed assets ratio was abolished to be replaced by a reserve assets ratio set at 15 per cent thus signalling the end for detailed specification of the structure of asset portfolios.

A major issue occupying much of the deliberations of the Campbell Committee was the extent of the relaxation of long-standing prohibitions on the entry of new banks, especially foreign ones. The then government, in January 1983, decided to allow the entry of up to ten new banks with foreign shareholders though there would be no restrictions on the number of new banks having only Australian owners. This commitment lapsed when the new federal government took office in March, 1983. By the end of that year the Australian dollar was floating freely and exchange controls had been abandoned. During following months authority to deal in foreign exchange was granted to many NBFIs, mainly merchant banks, while restraints on the forward currency market were removed.

The new administration convened a Review Group to consider and report on many recommendations in the Campbell Report including participation in banking by domestic and foreign interests and regulation of all financial intermediaries. That Group reported in late December, 1983. This Martin Report, named after the Chairman of the Review, recommended an increase in the number of new banks, to 6 new banking authorities, though foreign participation should be limited to 50 per cent of the equity in any one new bank. The federal government, in September 1984, called for applications for new banking authorities. Then in February 1985 sixteen foreign banks were invited to take up banking authorities while domestic groups were encouraged to seek banking authorities. The result was the entry of 22 new banks between 1985 and 1990.

By this time the strategic shift in the focus of market regulation was virtually complete. The RBA announced its general approach to prudential supervision and capital adequacy at this time. From then on remaining inhibitions on liabilities and asset management of banks were whittled away while the details of prudential supervision of banking were expanded steadily. With the abolition of the distinction between trading and savings banks in December 1989, segmentation within banking disappeared.

f) Appraisal

The pattern of shifts in the regulatory arrangements for the financial services sector, and especially for banking, is revealed as more adaptation to changing circumstances than abrupt change in direction. Market responses to comprehensive controls on banking business were revealed in the stimulus to growth of financial intermediaries not subject to regulatory authority. That growth led the authorities to ease some restrictions on banks in the sixties though it was not until the next decade that the tight web of controls really frayed. Even so the first half of the seventies saw a confusion of responses with relaxation of controls on the pricing and structure of banks' liabilities and assets matched by new restrictions on foreign exchange transactions.

Yet misgivings remained about the implications of this shift in strategy towards market allocation of financial resources for the conduct of monetary policy and, more importantly, system stability. The RBA questioned the skill and capacity of financial institutions to adjust to market changes in economic and financial conditions. Yet questioning had its origins in the experiences of 1974-75 while public submissions to the Campbell Committee on system stability issues came at about the time it was steering the rescue of the Bank of Adelaide by absorption into the ANZ Bank to which reference has already been made.

However imperfectly gleaned at the time, the abandonment of the postwar fixed exchange rate regime between 1971 and 1973 undermined domestic arrangements for controlling financial and foreign exchange markets. In an international setting allowing for great variability in exchange rate relativities, domestic interest rates could not be insulated fully from their repercussions. Moreover, expansion to a comprehensive range of financial instruments, and markets in which they could be traded, was supported by the activities of growing numbers of NBFIs, most notably the merchant banks, many of which were reliant on foreign affiliates and markets for some of the funding of their Australian activities. Means of access to financial intermediation, the hedging of risks and flexibility of portfolio management were extended greatly during the seventies and early eighties so that dependence on long-established financial institutions and markets had diminished.

The significance of contributions from the Campbell Committee may be exaggerated. Various measures had been introduced to bring greater diversity of choice, and flexibility in the use, of financial instruments well before this Committee was established. Furthermore the Campbell and Martin Reports were taken up mainly with banking and closely related themes with scant attention to direct financing and derivatives markets. The setting up of the Campbell Committee was a reflection of the
shift away from reliance on regulation in the financial services sector. Many of the Campbell Committee's recommendations endorsed the shift in policy implementation from reliance on quantitative and qualitative regulation of banks to the use of market-oriented instruments bearing upon the price and quantity of money and credit. But the measures introduced through the 'seventies were within the given institutional arrangements for banking even though new institutions had expanded the range of instruments elsewhere in the financial services sector. Where the Campbell Report initiated extraordinary change was in attention to market participation and conditions for entry into banking. Discussions of submissions to that inquiry created an atmosphere in which long-standing prohibitions on foreign participation in banking could be questioned. (22)

4. Ownership, Entry and Competition

a) The Old Pattern

Entry to banking and financial services was restricted for decades under various legislative and administrative determinations. Most notable was the prohibition on new foreign banks; a policy reaffirmed on a number of occasions from 1945 onwards by successive federal governments. Controls on foreign investment limited the equity holdings of overseas financial intermediaries in the various NBFIs though most significant for the merchant banks. In the securities industry the rules for membership of the exchanges comprising the Australian Associated Stock Exchanges (AASE) excluded corporations, domestic and foreign, because natural persons partnerships were the sole institutional arrangement permitted for members. Whereas the banks had been compelled early in 1975 to abandon their uniform fee structure as contrary to the Trade Practices Act, the AASE had secured an interim authorisation for both restrictions on membership and fixed commission charges. Insurance activities were dominated by the mutual provident societies, they having had their major brush with foreign entry almost a century before. (9, pp.114-128)

Just prior to the authorisation of the new trading and savings banks, the banking industry was dominated by four major banks; namely, Westpac Banking Corporation, Australia and New Zealand Bank (ANZ), National Australia Bank (NAB) and the Commonwealth Banking Corporation familiarly known as the Commonwealth Bank of Australia. These four had about 80 per cent of all banking business with the last-mentioned owned by the Australian Government and the other three publicly-listed companies. Other banks operating in Australia at this time were much smaller than these four. There were two foreign-owned banks of long residence, the Bank of New Zealand and the Banque Nationale de Paris. Apart from the minuscule Bank of Queensland there were a number of banks authorised under state legislation and not subject to federal banking scrutiny as is the case to this day. All being owned by respective state governments they were the State Bank of Victoria, State Bank of New South Wales, State Bank of South Australia and the Rural and Industries Bank of Western Australia. They held about 16.5 per cent of all banking business. Apart from the one in New South Wales, all had essentially savings bank functions. In 1981 an authority was given for a new trading bank, the Australian Bank, to commence business. Then in Tasmania there were two trustee banks operating as savings banks; the Hobart Savings Bank trading as the Savings Bank of Tasmania and the Launceston Bank of Savings.

This structure reflected a consolidation amongst a number of smaller publicly-listed banks over the previous thirty-five years. However, two of the majors - NAB and Westpac - were the result of mergers in 1982 being in preparation for the heightened competition from the expected entry of new banks. Three years before the ANZ Bank had absorbed the Bank of Adelaide when it was brought close to collapse by the failure of its finance company subsidiary.

b) Restructuring Financial Services

Separate from, through not independent of, initiatives in the banking sphere were the efforts to secure reviews of the interim authorisations by the Trade Practices Commission (TPC) of the restrictions on membership and fixed commissions in equities trading by stockbrokers. This quest, led by the Australian Merchant Bankers Association, forced lengthy hearings before the TPC. The outcome was the abandonment of fixed commissions with brokerage being determined from April 1984 with individual clients. The main effect was to benefit the large institutional clients, the various fund managers. Membership was opened to corporate entities. Within the decade the old natural persons partnership disappeared with most large brokerage firms owned by major financial institutions. Longer term effects of this major structural change have been the amalgamation of individual exchanges into the single Australian Stock Exchange (ASX) and the switch from trading floors to electronic screen trading. The massive changes in stockbroking were harbingers of events to come in banking.

When the decision to call applications for new banking authorities was announced in September 1984, the purposes to be served by authorising new banks were stated clearly. The two major features were:

(a) the development of a more innovative, efficient and competitive financial sector; and,
be against the national interest. For more than 15 per cent the applicant has to prove that the holding would be in the national interest. Moreover, the Government stated its willingness to relax the 50 per cent upper limit on foreign equity should a proposal for a banking authority be viewed as having significant benefits to the economy.

Loosening of the formerly rigid condition requiring at least 50 per cent local equity participation can only be understood in terms of the main aim of improved efficiency and competition in the financial sector. Should rigid application of that requirement have risked the absence of a potentially effective new bank then relaxation of the condition restricting foreign ownership was essential. Stimulus to efficiency and competition had become more important than the number and ownership of new banks. That possibility was presented much more unequivocally in the announcement on the restructuring of merchant banking with the provision waiving for twelve months from September 1984 all tests, including substantial economic benefits, constraining foreign ownership. The recommendation of the Martin Report on this matter was reflected in this decision, though possibly not to the extent of abandoning all tests. (28, p. 163)

Questions about foreign ownership along with the number of new banks to be authorised were the two dominating issues in the appraisals and critiques of proposals for opening up banking to new participants. The twin topics had been prominent in the deliberations of the Campbell Committee and then the Martin Review Group. That this should have been so is hardly surprising. Ownership and control of banks had a lengthy and controversial history over recent past decades most of all with the bank nationalisation issues of the late forties. Yet grounds for restraints on ownership have not been clearly specified while empirical evidence for their justification is inconclusive. (13)

The result of the opening up of banking to entrants was the introduction of twenty-two new banking groups with some seventeen having foreign ties. Of those there was provision in a number of the new banking authorities requiring Australian equity participation. Two new banks were each owned jointly by a foreign bank and a major Australian insurance group. The experiences of the new banks concerned have seen the erosion of this provision. The minority Australian participants in five banks have been bought out by their foreign principals; the remaining one is soon to follow. Of the two jointly owned new banks National Mutual Royal Bank has been absorbed into ANZ Bank while Chase AMP will revert to full foreign ownership by Chase Manhattan in 1992. Return to full foreign ownership within a few years from entry is

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8 It may be argued that the concentration on banking and related matters in the Campbell Report reflected the terms of reference of the inquiry. That interpretation is not convincing because banking is listed as one amongst a number of features of the financial system. (4, pp. xxii-xxv) Furthermore the Report devotes only 10 per cent of its coverage to taxation which is not a topic mentioned in the terms of reference; a feature pointing to a willingness to explore issues not specified.

9 The seventeen banks with foreign affiliations include the fifteen of the sixteen foreign banks invited to apply for new banking authorities which took up the invitations plus the Bank of China and Macquarie Bank. The last-mentioned bank has a 30 per cent foreign equity but that holding has only 10 per cent voting rights. (14, Appendix A)
ample witness to the dominance of concerns about efficiency and competitiveness in banking, and the financial services sector generally, over issues in ownership including Australian equity participation.

The striking feature of this experience is the rapidity with which a long-standing tenet of banking and financial policy shared by all major political parties, namely, restraints on foreign ownership, was abandoned to the perceived greater priority of competitive financial markets. Moreover, such equity restrictions as were imposed at the time new banking authorities were granted, were removed once competitive strains had led to the need for injections of new capital which local minority participants could not match. The Campbell Committee and the Martin Review did not recommend such a radical departure from the past stance. Government policy in 1985-86 went much further than most recommendations presented.

c) Response

The RBA has provided a helpful general perspective on changes in market participation following the authorisation of the new banks and the reconstruction of ownership in merchant banks from early 1985 onwards. A most useful summary on these changes is shown in Table 3 where the old or established banks as well as the new ones are shown separately but each grouped with their NBFIs subsidiaries. These two groups are then compared with the rest of the NBFIs which covers merchant banks, CMTs, finance companies, building societies, credit unions and other financiers not linked to banks, old or new. A sub-group of this third category shows the share of assets in the financial services sector held by those NBFIs affiliated to banks in other countries but which are not authorised banks in Australia.

The startling feature of this set of data is the sharp rise in the market share of the NBFIs affiliated to foreign banks not being authorised banks in Australia. The rise in their market share by more than 150 per cent between 1984 and 1989 is a remarkable outcome when the main focus of attention in banking and financial policy has been on the many new authorised banks. The gains of this group, admittedly from a very small base, outweigh those enjoyed by the new banks and their subsidiaries and exceed absolutely the market shares given up by the old banks and their subsidiaries or the rest of the NBFIs not tied to any bank.

The gains of the affiliates of non-resident banks were secured mainly in the period 1984 to 1987, a time when the new banks and their affiliates while expanding market share were taken up with adapting to new practices as banks. Longer term consequences for the extraordinary growth in portfolios have yet to be revealed fully though doubts about asset quality may be entertained if some evidence on practices in one instance is indicative of the competitive milieu.(29, pp.112-120)

Table 3: Financial Intermediation in Australia, 1984-89.

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<tr>
<td>1. Old Banks &amp; their NBFIs</td>
<td>(A) 68.0</td>
<td>64.0</td>
<td>64.0</td>
<td>65.5</td>
<td>-</td>
<td>-</td>
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<tr>
<td>2. New Banks &amp; their NBFIs</td>
<td>(B) 71.0</td>
<td>66.5</td>
<td>67.0</td>
<td>68.0</td>
<td>67.5</td>
<td>68.5</td>
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<tr>
<td>3. Other NBFIs</td>
<td>(A) 10.0</td>
<td>12.5</td>
<td>12.5</td>
<td>12.0</td>
<td>-</td>
<td>-</td>
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<tr>
<td>(a) Affiliates of non-resident banks</td>
<td>(B) 9.5</td>
<td>11.5</td>
<td>10.5</td>
<td>11.5</td>
<td>12.0</td>
<td>12.0</td>
</tr>
<tr>
<td>(b) Others</td>
<td>(B) 22.0</td>
<td>23.5</td>
<td>23.5</td>
<td>22.5</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Source: Series (A) - This data is taken from RBA published data. Series (B) - This set of data is based upon the ownership structures in 1989. Ownership restructuring from multiple to single ownership is not the only explanation for the market surge by affiliates of non-resident banks. Up to August 1988 the new banks as with the old ones, were required to hold statutory reserve deposits at the RBA on which they received a much less than market rate of interest. Furthermore the activities of the new banks in both banking and non-banking business were subject to close scrutiny by the RBA during those years immediately following entry. Affiliates of non-resident banks enjoyed a competitive advantage between 1985 and 1988 to the chagrin of the new banks most of all. Hence the performance recorded in Table 3 for these affiliates would be the zenith of their market penetration with the benefits of that competitive advantage gradually fading from balance sheets. When the market performance of these reconstructed affiliates of non-resident banks is compared with the new banks group there can be little wonder about the impact of all these changes being felt so much in wholesale rather than retail banking. The new banks were not alone in seeking market share in that aspect of financial intermediation. The opening up of the financial sector to new participants in 1985-86 was not just about banking but encompassed a broader spread of activities and new participants. This phenomenon is also a salutary reminder that the market for many financial services is not the exclusive preserve of banks. Yet it had been evident from the late 'sixties; the merchant banks particularly had brought or forced changes in regulatory arrangements bearing upon the competitive position of established banks.</td>
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5. Issues

The story of financial and monetary developments from the 'sixties is about a balancing act. Inertia maintained a status quo in the controlled sphere with modest relaxations reluctantly conceded while innovation drew customers toward newer intermediaries and their financial mechanisms. The authorities were hesitant in their acceptance of the innovating financing techniques being uncertain of the gains in market efficiency accruing to the users of financial services or the possible instability arising in a less regulated milieu. However, efficiency concerns could not be sustained in face of the extension in the range of financial instruments from the 'seventies onwards. Market participants were able to establish financing arrangements more appropriate to the real activities being pursued. Should the arguments favouring continued regulation have included issues about market failure owing to the incompleteness of existing financial markets, with the innovations of the 'seventies having brought a much more complete set of markets to Australia, one major ground for maintaining quantitative and qualitative regulations was removed.

The changing technology of communications complemented the development of derivative financial instruments and the markets in which many of them, most of all futures and options, were traded. The same phenomenon brought a greater integration of national financial markets with international ones, especially the eurocurrency markets. Banks and their larger customers were ever less confined for their funding to financial markets in their countries of domicile. For much the same reasons stockbrokers and their clients had greater ease of choice between transactions in Australia or stockmarkets elsewhere. These developments through the 'seventies and early 'eighties may explain the later acceptance by the Australian authorities of the need for swift termination of restraints on entry, ownership and foreign exchange markets in the quest for perceived greater efficiencies in financial markets and policy implementation. By that time adherence to regulatory measures had become a voluntary act for many market participants.

Nowhere is this balancing act better represented than in Professor Harper's contribution of the middle 'eighties. There he spells out the many caveats expressed by the authorities in their submissions to the Campbell Committee on the rapid abandonment of controls and the need to moderate the speed of adaptation. These features also help understanding of the ambivalent policy stance on banking regulation during the latter half of the seventies.

Despite the seeming inevitability of the march towards deregulation, important questions remained about the timing, extent and institutional arrangements for change.

Neither of the two independent reviews recommended the sweeping changes of 1983-86. The explanation must rest upon a changed perception of the effectiveness of market determinations in securing the goals of economic strategy. The focus of policy did change and this is best witnessed in the ways the monetary authorities shifted from concerns about macroeconomic policies and system stability in their statements before the Campbell Committee to a support for market efficiencies and their complementarities with growth exemplified in the stated goals for entry of new banks.(12, 17)

This shift in focus also helps an understanding of the relatively slow and not always consistent development of institutional arrangements appropriate to a much changed and more competitive financial services sector. System stability issues did not disappear from contention. An early response to the Campbell and Martin reports explored the many difficulties for supervising banking within a competitive financial sector.(6) Methods of prudential supervision were much slower to devise and implement than the sharp switches in competitive arrangements.(15, 20) The reason for this discordance in responses must lie in the identification of market efficiency with market stability, a position assuming a smooth transition from one set of institutional arrangements of markets to another markedly different set. An implicit assumption was that each financial intermediary would manage effectively its risk exposures. In effect, concerns for application of macroeconomic policy measures and system stability were to be relieved by market determinations.

a) Efficiency and Market Adjustment

At issue is the strength of the conviction that market determinations would bring system stability as well as gains in market efficiency. Underlying this proposition is the perception of some stable outcome following the entry of new banks and the restructuring of the merchant banks. This position may be interpreted as reflecting a notion of competitive equilibrium. Yet the experiences of the past six years do not suggest the achievement of such an outcome. Nowhere is this more clearly stated than in the comments of Professor Valentine when treating the expectations of the Campbell Committee; "There were some areas ... which the Committee failed to predict .... (including) .... the slow rate of adjustment to deregulation ....". (35,p.58) In these remarks is found disappointment with the failure to secure convergence towards a stable outcome. Instead there have been failures and mergers as well as exits along with restructuring of ownership amongst banks since 1986.(14) The expectation is for this experience to continue.

In these circumstances an examination of the theoretical structure which gave rise
to the commitment or conviction on the effectiveness of market outcomes may be helpful to understanding what has taken place. The basis of contemporary models of efficient markets rests upon an assumption which generates convergence to equilibrium. As it set out in the Appendix this convergence assumption rests upon a set of conditions which link directly the expected rate of return on an asset, or the market portfolio of assets more appropriately, to the rate of growth of the asset price or the price performance of the market portfolio. Convergence is secured when the rate of growth of asset prices is less than the expected future rate of return. That rate of return is the rate whereby future earnings are discounted to provide the present value of the asset or market portfolio. But that rate of return rests upon the assumption of perfect competition.

The test of convergence or otherwise then rests upon the relationships between familiar financial ratios, the price-earnings ratio and the dividend-earnings ratio. With the former it would be a sustained rise in the ratio and for the latter a sustained fall. The presence of either would point to the presence of speculative bubbles which is what is implied when the convergence assumption is rendered inoperable.

Convergence issues had been tested in the years immediately before and at the time of the opening up of financial markets in Australia. Foreign exchange markets were tested by the relative strength of the U.S. dollar to other currencies as compared with the perceived real value of that currency. The explanation for that "overvaluation" is in terms of a speculative bubble. But that contemporary experience must have been passed over by the authorities at the time of financial restructuring in Australia. Convergence was not only an implicit assumption in the strategy for deregulation but also it would be prompt.

Scrutiny of the Mandelbrot-Samelson analysis summarised in the Appendix does not reveal any firm basis for a prompt convergence to equilibrium. That analysis offers insights to the adjustment process and disturbances to it. On the speed of adjustment the analysis is not forthcoming.

One caveat must be entered. The expected prompt adjustment process may have been thwarted by the macroeconomic policy setting. During the years under review the fiscal programme worked gradually towards surpluses in the Federal Government's budget. This was not matched by comparable restraints in monetary affairs. In Table 4, estimates for the growth of money supply are shown for Australia and some major trading partners. The Australian series shows a much higher rate of growth than similar series for the other countries. Only at the end of 1989 was the series recording growth rates comparable with the experiences elsewhere. There are problems with measuring money supply changes in Australia owing to shifts in the use of funding instruments reflecting adaptation to changes in regulatory provisions affecting banks and other financial intermediaries in varying ways. However, the differences between the Australian series and those for the other countries are so large for some years as not to be explained by measurement problems.

<table>
<thead>
<tr>
<th>Table 4: Growth of Money, 1986-90</th>
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<tr>
<td>Annual percentage change</td>
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<td>1986 December</td>
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<td>1992 December</td>
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<td>1993 June</td>
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The series in Table 4 do point to a relatively easy setting for monetary policy in Australia when compared with what was taking place elsewhere. In this easier setting may be found some explanation for the perceived slow adjustment towards a stable outcome in the financial services sector of the economy. In a broader context this serves to point up the handicap to securing a stable outcome in one sector of the economy when instability exists in others.

b) Information and Market Adjustment.

Explicit in the market efficiency models was the treatment of the information by which decisions on asset prices are made. That this feature is embedded in the market efficiency doctrines is also set out in the Appendix. In its weakest form the information necessary for an efficient outcome is the history of all past prices, values and related information about the place of assets within the general structure of markets and the economy in which they are located. Given that setting the efficient markets model provides on outcome in which all market participants are on an equal footing; there is no scope for devising trading rules in asset markets which would allow the sustained

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10 An argument that the existence of many new banks and merchant banks in a situation where exchange controls had been removed created the conditions whereby funds could be drawn from foreign capital markets regardless of domestic monetary and financial policies is not convincing. The implication is that Australian authorities were powerless to influence domestic conditions which would suggest unique features not shared with other economies.
earning of returns in excess of the market rate of return.

The strength of this position on market efficiency may be tested against recent experiences in the Australian economy. The point has been made that earnings and rates of return on some financial assets have been consistently low in real terms over lengthy periods. This would not suggest prompt responses to market opportunities, or at the very least, a delayed response to changing market conditions. From another perspective this would suggest a very slow adaptation of expectations. These are circumstances where some participants could secure returns consistently higher than the market rate over lengthy periods.

A separate issue is the ability of entrants to markets to have grasped the historical experience of Australian financial and economic conditions. There was passing commentary throughout the paper on past failures of intermediaries such as followed strained asset markets in 1974. It is as if the assumption of known historical experience, the weak-form efficiency concept, does not hold. This is suggestive of degeneration of the information stock with experiences “lost in the mists of time”.

A most perceptive appraisal of this possibility is offered in the work of Maurice Allais. He brings to the topic the concept of forgetfulness as a measure of this degeneration. In his work the measurement of this phenomenon is akin to depreciation of physical stock. For Allais the process of discounting the memory of the past is no different from discounting expected earnings to secure the present value of an asset. While the context in which the concept was advanced was not related directly to the efficient markets hypothesis, its significance is clear. The history of all past prices and values is not known so that conditions for obtaining an efficient market outcome are not met.

The direct relevance of these points to the experience of financial deregulation in Australia is to cast light on the weaknesses in the assumptions underlying the strategy. The commitment to market efficiency rested on some quite fragile assumptions about informed markets. Moreover, this stance does not allow the possibility that entrants might have had goals other than returns on a portfolio, most obviously the securing of market share. This possibility is damaging to convergence notions.

6. Summary Views

The lengthy review of the strategic shift from a regulated financial services sector to a deregulated one, as defined in the restricted meaning of those terms referred at the beginning of this paper, provide some insight to the timing, purpose and impetus for changes. The process has not been one of abrupt shifts. However, the interpretation of these events differs. The inevitably limited coverage of events points to an erratic adaptation to changing circumstances arising in foreign as well as domestic experiences. Adaptation has not always been consistent, most of all as witnessed in the ‘seventies.

By the middle of the ‘seventies the domestic financial services sector was exhibiting an ever increasing diversity with growth in the variety of markets and financial instruments. By the early ‘eighties availability of comprehensive set of financial markets and instruments was complete when the abandonment of exchange controls gave access to financial markets anywhere.

Where the Campbell Committee and the Martin Review Group had the greatest influence was on the numbers participating in banking and related activities. Yet their recommendations were modest when compared with the decisions taken by the Federal Government. With the twin decisions on entry of new banks and the restructuring of the merchants, the competitive situation was changed fundamentally. There were many more independent entities, not just banks but merchant banks also, in the financial services sector. The competitive impact was on transactions costs and the squeezing of economic rents arising in segmentated markets to which entry had been restricted. Undoubtedly the much larger number of new entrants than had been anticipated increased competitive strain. However, the restructuring of the ownership of merchant banks has proved to be most significant in the initial opening of financial markets to entrants, a shift now understood fully for its implications at the time. Yet the merchants banks were for more than a decade prior to the sweeping changes of the middle ‘eighties, the main influence for the whittling away of the boundaries between segmentated markets.

This strategic shift in banking and financial arrangements had brittle foundations. The effectiveness of market determinations in securing system stability and efficient resource allocations was taken as being as applicable to a massive change in structural and institutional arrangements as to smaller progressive adjustments witnessed over more than a decade prior to the middle ‘eighties. Yet there was no firm analysis to support that stance; the images of stable outcomes were not secure.
However, the workings of financial markets, regulated or not, are not independent of macroeconomic conditions such as the balance of payments, fiscal performance and monetary policy. The authorities set the conditions in which intermediaries have to perform. But that requirement was lost from sight, or partially so, in the welter of events in the middle years of the 'eighties.

Appendix

Market Efficiency and Stability

The efficient markets model which underlies most discussions of the workings of financial markets rests upon an assumed state of knowledge, or information, \( \Phi \). Market participants are assumed to make effective use of whatever information they have. In as much as all relevant information is discounted in asset prices as soon as it becomes available, there is no scope for constructing trading rules systematically and consistently profitable. This approach owes its origins to Fama whose contributions have dominated the appraisal of efficient capital markets for two decades. (7) This led to the devising of the three-way categorisation of information in relation to market efficiency: “weak form” efficient should the information set be purely the historical records of prices, returns and related information, “semi-strong-form” efficient when the set embraces all publicly held information and “strong-form” efficient when the information set included confidential as well as public information.

It is not the function of this note to review the ambiguous qualities of this approach to defining efficiency. The tautological features of the analysis have been treated some time ago. (11)

Indeed the specification of conditions appropriate to the analysis of efficient capital markets is identified with the work of Mandelbrot and Samuelson having their origins in the middle sixties. (21, 30, 31) Despite the development of their models prior to much of the dominant analyses of securities markets, the significance of their work for understanding the stability conditions for efficient markets has been overlooked.

The simplest representation of the efficient markets model is given by:

\[
E(r_{jt} | \Phi_t) = \rho
\]

where

- \( r_{jt} \) = rate of return on \( j \)th asset
- \( \Phi_t \) = market participants' information at time \( t \)
- \( E(.) \) = conditional expectation given \( \Phi \)
- \( \rho \) = expected rate of return on the asset given perfect capital markets and risk neutrality.

This equation (1) states that, whatever the information set, asset prices will depend on these values in such a way that the expected rate of return on the \( j \)th asset is always \( \rho \). It must be stressed that the equality of the expected return on all financial assets depends upon the existence of perfect competition and the reality of risk
Proceeding similarly \( n-1 \) times, there results:

\[
P_t = \frac{E(d_{1,m})}{1 + \rho} + \frac{E(d_{2,m})}{(1 + \rho)^2} + \ldots + \frac{E(d_{n,m})}{(1 + \rho)^n}
\]

\[+ \frac{E\left(p_{n,m} + d_{n,m}\right)}{(1 + \rho)^n}\]  \hfill (5)

Assuming that \((1 + \rho)^n E(p_{t+n})\) converges to zero as \( n \) approaches infinity, (5) becomes the familiar present-value equation:

\[
P_t = \frac{E(d_{m,t})}{1 + \rho} + \frac{E(d_{m,t+1})}{(1 + \rho)^2} + \ldots
\]

\[+ \frac{E(d_{m,n})}{(1 + \rho)^n}\]  \hfill (6)

How might equation (6) be interpreted? Suppose dividends are expected to rise(fall). The price of the asset will be high(low) compared with present dividends, by which is meant recent past dividends, so that the price of the asset will be high(low) relative to those present dividends. When dividends do rise(fall) no abnormal returns will be earned. Holders will earn positive(negative) abnormal returns only were dividends change more(less) than had been expected. If capital markets are efficient, the generally held expectation of a dividend increase does not imply that that asset should be traded as the expected increase is already reflected in market price.

But this explanation is not the prime interest for this note. The derivation of the expected present-value equation(6) from the efficient capital markets equation(1) rests on the assumption that \((1 + \rho)^n E(p_{t+n})\) converges to zero as \( n \) approaches infinity. This convergence assumption is readily interpreted. The asset price is expected to grow more slowly than the rate at which future returns are discounted. Rejection of this convergence assumption would mean speculative bubbles. Despite price exceeding the discounted value of expected dividends, investors are willing to hold assets because it is anticipated that price will exceed expected dividends by an even wider margin in the future.

The test of this convergence assumption may be found in analyses of price-earnings ratios and dividend-price ratios. Any downward trend in the latter when
sustained for a period would point to speculative influences while high price-earnings ratios would likewise point to the presence of the same phenomenon.

The Australian experiences between 1986 and 1989 may offer confirmation of market bubbles, at least in some segments of asset markets. Tests in other markets are revealing.(36)

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