

# A NEW FINANCIAL REVOLUTION?

*An international review of the Campbell Report*



Malcolm Fisher ● A.R.Prest ● Michael Parkin

Geoffrey E.Wood ● John F.O.Bilson ● Tim Congdon

THE CENTRE FOR INDEPENDENT STUDIES

352 ON

FIS

## THE CENTRE FOR INDEPENDENT STUDIES

The CIS is an independent Australian economic and social research institute concerned with the principles underlying a free and open society. An essential requirement for a healthy free society is that public policy decisions should not be dominated by one particular view or set of views. If ideas are not tested by competition then public policy decisions may undermine rather than support the foundations of a free society. In encouraging competition in ideas, the Centre for Independent Studies:

- \* conducts research on its own account
- \* encourages outside scholars to investigate important issues and develop programs of research
- \* publishes the results of its researches
- \* provides forums for the public discussion of important social issues
- \* promotes the results of its studies to the public-at-large

The research work of the CIS is assisted by a Council of Advisers and supervised by a Research Committee. Members of the Advisory Council include:

Professor H.W. Arndt  
Professor Ray Ball  
Professor R.J. Blandy  
Professor Lauchlan Chipman  
Professor Ken Clements  
Professor Malcolm Fisher  
Dr Knud Haakonssen  
Professor R.M. Hartwell

Professor F.A. Hayek  
Professor Warren Hogan  
T.H. Kewley  
Dr Naomi Moldofsky  
Professor R.R. Officer  
Professor Ross Parish  
Professor C.G.F. Simkin  
Professor Cliff Walsh

The Centre is constituted as a Company limited by guarantee and is independent of any political party or group. It is financed by sales of its publications and by voluntary subscriptions and contributions from individuals, organisations and companies.

Executive Director  
Greg Lindsay

---

Orders for publications and subscription enquiries should be addressed to:

The Centre for Independent Studies,  
375 Pacific Highway, St. Leonards, NSW. 2065.  
Telephone (02) 4384377

# A NEW FINANCIAL REVOLUTION?

CENTRE FOR  
INDEPENDENT  
STUDIES

CIS

~~302~~

57b

## **A NEW FINANCIAL REVOLUTION?**

An international review of the Campbell Report

Malcolm Fisher (ed.) ● A. R. Prest ● Michael Parkin  
Geoffrey E. Wood ● John F. O. Bilson ● Tim Congdon



THE CENTRE FOR INDEPENDENT STUDIES

1982

First published February 1982 by  
The Centre for Independent Studies  
*All rights reserved*

National Library of Australia

Cataloguing-in-Publication Data

A New financial revolution? An international review of  
the Campbell report.

Includes index  
ISBN 0 949769 04 5

1. Committee of Inquiry into the Australian  
Financial System. Australian financial system.  
2. Finance - Australia. I. Fisher, Malcolm R.  
(Malcolm Robertson). II. Centre for Independent  
Studies (Australia). (Series: CIS readings; 3).

332'.0994

\* The Centre for Independent Studies 1982

## Contents

Preface	vii
<b>1</b> INTRODUCTION The Mystical World of Money and Finance Malcolm Fisher	1
<b>2</b> OFF TARGET ON MONETARY STABILISATION ISSUES Macroeconomic Aspects of the Campbell Report Michael Parkin	23
<b>3</b> AUSTRALIAN FINANCIAL REFORM Implications and Alternatives John F.O. Bilson	37
<b>4</b> COMPETITION, INNOVATION, CONSUMER PROTECTION AND THE ROLE OF THE MARKET The Philosophy of the Campbell Report Geoffrey E. Wood	59
<b>5</b> THE FISCAL ASPECTS OF THE CAMPBELL REPORT A.R. Prest	77
<b>6</b> COMPETITIVE NEUTRALITY The Key Concept in the Campbell Report Tim Congdon	93
Further reading	112
Index	113

## Preface

When the *Final Report\** of the Committee of Inquiry into the Australian Financial System (the Campbell Report) was released in November 1981, many were surprised and unprepared for the sweeping reforms that the Committee had recommended. It would be fair to say that the diligence with which the Committee went about its task is at least the equal of any previous government inquiry and the thoroughness with which economic analysis has been applied should, if nothing else, be good reason for the Government not to ignore its recommendations. While some may disagree with the terms of reference - in particular the Government's free enterprise objectives - from which the Committee worked, if the object is to improve the lot of all sectors of the Australian community, then most economists would believe (while perhaps differing on details), that the prescriptions laid down in the Report will indeed move us some way along the path to this desired state.

But there are beneficiaries of regulation (some of the regulated; those members of the community who, for example, may have cheap loans; and the regulators themselves who may have nothing much to do if Australia moved along a deregulatory path) who have been heard grumbling, both openly, and furtively as they line up counter-arguments. It is thus crucial as the debate ensues, that a careful and objective study be made of all arguments for and against changes to the system.

The Centre for Independent Studies established its *Readings* series so that important issues may be examined from a number of points of view. It was felt that the results of the Campbell Committee's work would be of such significance in the consideration of future public policy, that a volume of essays examining the principles underlying financial reform and written by specialist economists from around the world, would be a unique contribution to the analysis of the Campbell Report. It was of course impossible

---

\* Committee of Inquiry into the Australian Financial System (J.K. Campbell, Chairman), *Final Report*, AGPS, Canberra, 1981.

to cover every detail of the *Report* and this was not the intention of this collection.

Assembled in this volume is the product of some speedy work on the part of the contributors and they are to be congratulated for producing what they have in such a short time. Special thanks must go to Professor Malcolm Fisher who guided the book from its inception.

A financial system, of whatever form, affects every member of society. No matter what the outcome of the recommendations for reform by the Campbell Committee, discussion on the financial system is unlikely to proceed without detailed reference to the *Report's* findings. In publishing this volume, the Centre for Independent Studies feels that a significant contribution will be made to the discussion on the important issue of financial reform. Nevertheless, the conclusions presented here are those of the authors and are not necessarily shared by the Centre, its Advisers, Trustees, Directors or officers.

January 1982

Greg Lindsay



# 1

## INTRODUCTION

The Mystical World of Money and Finance

Malcolm Fisher  
*Australian Graduate School of Management*

**Malcolm Fisher** is Foundation Professor specialising in Economics at the Australian Graduate School of Management, University of New South Wales. Previously for 25 years he was University Lecturer in Economics Cambridge University and also Fellow and Director of Studies in Economics at Downing College. He has continuously lectured on money, finance and macroeconomics though his specialist fields also include consumer behaviour and labour economics. He has taught at Auckland University, been a Research Officer at the Oxford University Institute of Statistics and held Visiting Professorships at the Universities of Chicago (1968) and University of California, Los Angeles (1971, 1974 and 1981). Apart from articles in learned journals his publications include *The Economic Analysis of Labour*, *Wage Determinations in an Integrating Europe*, and *The Measurement of Labour Disputes and Their Economic Effects*.

## INTRODUCTION

The Mystical World of Money and Finance

Malcolm Fisher

### I. INTRODUCTION

#### Properties of money

Very early in the development of trading, man came to appreciate the advantages of money as something that another would accept in settlement of goods traded. In this sense it served to reduce the delays and inconveniences in trying to exactly match the offer of goods by one party by the offer of goods of another. Money generalised exchange. So great were these advantages, that men chose to keep some of their wealth in a form that facilitated exchange. At different stages this monetary role was taken by cattle and corn, eventually with metals, such as gold and silver, becoming the popular medium. Money in these times then was something people found advantageous to provide for themselves, despite the costs involved.

Just as one always seeks less costly ways of making goods and providing services, so men sought and found less costly ways of providing the monetary media. Since assessment both of quantities of money in these traditional forms and of their qualities proved difficult, methods were evolved whereby government certified the monies centrally in acceptable ways. Hence we see the movement to coin, and later to notes, culminating in today's usage of bank deposits transferable by cheque, and credit card facilities, the latter providing a peep through a window at the world of electronic transfers that lies not far ahead. Some of these facilities are very recent introductions in any developed country - the financial revolution lagged behind the agricultural and industrial revolutions. Indeed much of the modern system of financial intermediation is post-war in significance, if not in initiation. Nevertheless the process is one of evolution from the earlier media, the same characteristics surviving in the new forms, but being cost efficient in practice. At bottom, acceptability depends entirely on trust, not trust in intrinsic value as such, but in conveying assurance that such media will perform efficiently the tasks for which they were originally sought.

## *A New Financial Revolution?*

One might expect that the trust accorded to a country's money might be an important determinant of a chosen country of residence. Under modern conditions of ease of travel it could be, though within broad limits there may be offsetting factors. To some extent one can trade in moneys internationally rather than move oneself. For example there have been periods post World War II when many persons have elected to hold monies in Swiss numbered bank accounts or in major trading currencies such as the yen or the deutschmark when there have been seen to be weaknesses in one's own currency.

Further, monies that work well at one time may not do so at another. Any deterioration in trust strikes hard, slowing the speed of growth in real income through specialisation and trade that money should foster. One needs to preserve and develop the good properties of a monetary system and minimise the propagation of adverse properties. The good properties are fairly clear - trust, flexibility and, in a sense, equity. What then are the bad properties?

To appreciate this we ask ourselves why Australians might prefer to hold, say, Swiss francs to Australian dollars. The most direct reason would be because, relatively, we would distrust our own government. A government is basically the guarantor of the money supply, but it is also the body with the power to tax, spend, borrow and lend, and overall the power to enforce, since it controls the effective means for ensuring internal and external safety of the realm. Western-style democracies were not the first to abuse fiscal and monetary powers. Kings of old, and doubtless chieftains before them, exercised their autocratic powers. Kings debased the coin of the realm and governments in recent centuries have periodically resorted to the printing press to supply the notes necessary for them to match their excess of spending over taxation. No tax can be more insidious than the invisible (or less visible) creation of money. For a time governments have been able to gain the confidence of their electors or subjects by appearing to expand trade and production through money creation - but it is quite apparent that at other, and later, times they have lost it. When inflation is resorted to, persons rearrange their disposition of funds, placing them in safer locations, commodities, or transferring them abroad. To the extent that such movements become widespread, the costs of making further switches rise, and ultimately in sheer defence, people 'play safe' by reducing the degree of open specialisation and exchange. Thus the growth in national income is arrested

and paradoxically, 'safety' is reduced for the community at large.

A medium of exchange and a store of value is of such convenience that even under conditions of real adversity, a fall-back money can always emerge, such as cigarettes in prisoner-of-war camps. If state-supplied and endorsed monies fail to fulfil this role, alternatives will be resorted to. But clearly they must be less efficient or they would not have been bypassed in more favourable times. This has led Professor Hayek<sup>1</sup> to argue that since modern states seem unable to keep their hands off the printing presses - in the false expectation (or at least the propaganda) that employment can be created in this way, competitive private monies should be officially sanctioned. Ultimately of course, such a movement cannot be arrested, but more overtly efficient alternatives could be used if governmental sanction was forthcoming. Ultimately, as Germany and Austria in 1922-23 bear witness, Government monetary mischief can be checked, though at considerable cost. Could what happened there happen here? Hayek's argument is essentially one for building up the safeguards against such eventualities. In a similar vein, though with qualification, Henry Simons<sup>2</sup> has remarked:

An enterprise system cannot function effectively in the face of extreme uncertainty as to the action of monetary authorities or for that matter, as to monetary legislation. We must avoid a situation where every business venture becomes largely a speculation on the future of monetary policy. (p. 27)

If such a view could be expressed in 1936, how much more relevant would it seem today? Is it true that, 'For generations we have been developing financial practices, financial institutions, and financial structures which are incompatible with the orderly functioning of a system based on economic freedom and political liberty.'<sup>3</sup>

---

<sup>1</sup> Hayek, F.A., *Denationalisation of Money*, Institute of Economic Affairs, London, 1976

<sup>2</sup> Simons, Henry, 'Rules Versus Authority in Monetary Policy', *Journal of Political Economy*, 1936, p. 2

<sup>3</sup> Simons, *op. cit.* p. 1

## II. MONEY AND FINANCE IN CONTEMPORARY AUSTRALIA

In a modern, western-style democracy such as Australia money is created in three ways once the power to do this passes to the state and trust in that arrangement becomes consolidated.

1. By trading banks as a natural extension of the 'cloakroom banking' of the early goldsmiths who found that valuables brought to them for safekeeping would not all be reclaimed suddenly and simultaneously. Some could then be lent out at a profit and yet recovery could be assured in time to meet the depositors' demands upon the facility. Trust in the organisation could be combined with enhanced profit by lending. Adam Smith in 1776 when issue of banknotes was still the prerogative of commercial banks wrote

they [the Scottish Banking Companies] invented therefore another method of issuing their promissory notes by granting what they called cash accounts, that is by giving credit to the extent of a certain sum to any individual who could procure two persons of undoubted credit and good landed estate to become surety for him that whatever money should be advanced to him, within the sum for which credit had been given, should be repaid upon demand, together with the legal interest. Credits of this kind are, I believe, commonly granted by banks and by bankers in all different parts of the world.

That surely is a description of the overdraft (or loan) system of our banks embracing as it does the central properties of **accepting** (credit referees) and **discounting** (making marketable at a cost) that apply to all financial instruments, predominantly paper IOUs. These lead us into the burgeoning world of financial intermediaries with their associated specialist instruments, that come into being in the same way as specialist marketing organisations (and as occupations develop in the production and distribution of goods and services). 'The division of labour is limited by the extent of the market', to quote one of the most famous remarks of Adam Smith applies

---

<sup>1</sup> Smith, Adam, *The Wealth of Nations*, Pelican, Middlesex, p. 395

also to the world of finance.<sup>3</sup>

2. By the central bank (Reserve Bank of Australia) in its role as regulator of the money supply. This supply is augmented or reduced through specific controls over the assets of member trading banks or through buying and selling new or second hand (re-discounted) IOUs of approved standing (accepting) through prospectus or the stock exchange. Via the same process, Government can insist that any shortfall in the sale of its own securities should be absorbed by the central bank which in writing a cheque on itself, adds directly to the money supply. Government issues of debt cover the balance between expenditures and taxation receipts and may cover seasonal disparities or more persistent deficits. Those that are not absorbed directly by persons or firms because the yields are not attractive, are absorbed in this way.
3. By any net inflow (outflow) of funds across the foreign exchanges occurring because temporary or persisting constraints are placed upon the appreciation (depreciation) of the Australian dollar internationally. Such net domestic placement of foreign money involves Government purchasing these funds to augment foreign currency reserves and paying for them by cheques drawn on the Reserve Bank in favour of the depositors. When these are paid into a domestic clearing bank, the money supply is raised thereby and further expansion in money is facilitated as under (1) above. The converse mechanism applies for a withdrawal of foreign funds. A fully flexible exchange rate would obviate any money creation (or destruction) under this head.

The public at large can influence the size of the money supply, too, notably by its degree of willingness to use the 'cloakroom banking' system set out in (1) above.

The sum of these three items would be contained within any expert's total of money circulating in Australia today. Some would add other items about which there is less unanimity, for example, savings banks deposits.

From this base, the modern financial system extends in innumerable directions, embracing savings banks, merchant banks, life assurance and general insurance companies, building societies, credit unions, finance companies,

---

<sup>3</sup> Smith, *op. cit.*, Chapter 1

## *A New Financial Revolution?*

superannuation funds and so on, each of which in its way gives access to specialised or at least differentiated services.

Whereas in ancient times people developed their own money, in contemporary conditions, the primary source of money upon which the superstructure is built comes under 2. Based upon the net inflow from this source, the credit-creating powers of trading banks are unleashed; and from these in turn the other financial intermediaries derive their basic facilities or indeed their ability to support any extended range of IOUs issued - acceptability of which, though fairly general, is of a lower order than traditional money itself. This developing range of IOUs has been partly induced by desire for specialised services relative to cost and partly by constraints imposed upon some alternatives that have fostered the growth of other IOUs.

We have seen that even without governments, men will provide primary money for their own expanding needs of commerce. Indeed they may use less marketable IOUs for this end. But evidently economies can be secured by specialisation in supply; and among the alternatives, government issue and endorsement of quality appear to have advantages, and in general to dominate the market of financial intermediation. But government is also equipped with taxing power which, when abused (whether by king or modern parliaments) can remove the advantages that government may offer in the provision of monies.

Looking back over the last ten or fifteen years in relation to, say, the last two hundred, modern scholars and certainly historians would unhesitatingly emphasise the extent and persistence of inflation and the undue expansion in the monetary media that have accompanied it. Abuse therefore seems to have played a strong part in modern monetary and fiscal activities of governments, and societies have suffered all the distortions that go with this. We cannot help but note that countries that have shown least expansion in their monetary bases, such as Austria and Germany, are the very countries that experienced frightening rates of inflation in the nineteen-twenties. Once bitten, twice shy. Britain, Australia and the USA are still having the first bite. It may also be noted that whereas there have been periods when money expansion has been associated with substantial increases in real output, the last decade is evidence that there are times when real output has been very sluggish, though money expansion especially rapid.

Money, it would seem, is an uncertain ally in the process of development. Skill is required to harness its good, whilst avoiding its bad, properties.



### III. THE 1981 CAMPBELL REPORT

It is against this background that we must assess the *Interim and Final Reports* of the Australian Financial System Inquiry (hereinafter referred to as the *Campbell Report* after Mr J.K. Campbell, its most effective Chairman), the first report of such character since the Royal Commission into the Monetary and Banking System of 1936,<sup>6</sup> and the first since the Reserve Bank of Australia acquired its present status in 1945. In this interval of about 45 years, Great Britain has had two such investigations, the *Radcliffe Report* of 1959<sup>7</sup> and the *Wilson Report* of 1980.<sup>8</sup>

The terms of reference of the Inquiry are very specific and read:

In view of the importance of the efficiency of the financial system for the Government's free enterprise objectives and broad goals for national economic prosperity, the Committee is asked to:

- (a) Inquire into and report on the structure and methods of operation of the Australian financial system including the following institutions:
  - (i) banks and non-bank financial institutions including in relation to foreign exchange;
  - (ii) the securities industry generally;
  - (iii) the short-term money market, both official and non-official segments;
  - (iv) specialist development finance institutions including the Australian Resources Development Bank, the Australian Industry Development Corporation, the Commonwealth Development Bank and the Primary Industry Bank of Australia; and
  - (v) the Reserve Bank of Australia.
- (b) To inquire into and report on the regulation and control of the system.

---

<sup>6</sup> Royal Commission into the Monetary and Banking System, 1936.

<sup>7</sup> HMSO, Committee on the Working of the Monetary System, Cmnd 827, August 1959.

<sup>8</sup> HMSO, Committee to Review the Functioning of Financial Institutions, Cmnd 7937, June 1980.

## *A New Financial Revolution?*

- (c) To make recommendations:
- (i) for the improvement of the structure and operations of the financial system;
  - (ii) on the regulation and control of the financial system; and
  - (iii) concerning the existing legislation relating to the financial system including more importantly the Reserve Bank Act, the Banking Act and Regulations, Financial Corporations Act, etc.
- (d) To inquire into and report and make recommendations on such other matters as the Inquiry believes relevant to the generality of its inquiries.

The composition of the Committee was exclusively drawn from business - participants in the finance world, housing and accountancy, trading and Reserve Banks, financial advising, merchant banking and life insurance.

The two Reports are voluminous and detailed, covering virtually all relations involving financial intermediaries and their interaction with the private, public and overseas sectors including the impact of taxation and governmental borrowing.

## **IV. THE AUSTRALIA THAT CAMPBELL SAW**

The main features are set out in the *Interim Report* of May 1980. The Committee notes the dramatic growth in the overall public sector borrowing requirement in the second half of the seventies - the public deficit referred to earlier - and the movement in the pattern of public debt towards shorter maturities. Interest rates recently have been high in nominal terms but low, and sometimes negative, in real terms. Interest rates associated with housing and overdrafts have been controlled and have tended to lag behind the general level of rates. Corporate dividend yields have risen more slowly than fixed interest returns and have tended to move inversely with them. Increased flexibility has been brought into exchange rate determination (though stopping short of a free market) with a so-called 'flexible peg.' Capital controls on foreign dealings have persisted though there is an increasing sensitivity of short-term capital flows to the covered interest differential (interest rate differences between home and abroad - for comparable risk and term - with an allowance for exchange risk and costs of dealing). These features, we might remark, emphasise the importance of money creation under 2 and 3 and high nominal rates tend to accompany rapid price inflation.

The range of IOUs has broadened, and also intensified within a number of categories such as the commercial bill, inter-company dealings, and options and futures markets. These changes have gone in parallel with the marked increase in number and diversity of financial institutions, with the lines between traditional and new institutional forms and these among themselves becoming more blurred. The sixties witnessed marked growth in building societies, finance companies and merchant banks. Business has shifted its balance from equity towards debt financing and an increased proportion of the former now comes from institutions. This is facilitated by the household sector's relatively greater contribution to savings and its developing preference for investment through institutions notably in short-term deposit-taking concerns as opposed to long-term savings ones. Housing finance and personal loan facilities figure prominently. After-tax rates of profit on corporate capital were stable in the sixties and early seventies but less secure subsequently.

The *Interim Report* reviews the whole gamut of regulations and controls bearing on the financial system, especially insofar as they have direct effects on the pattern of supply, together with the reasons stated or implied, for their existence.

Clearly the field is enormous as the *Interim Report* alone covers 572 pages with a further 838 in the *Final Report*, not to mention appendixes and supporting papers.

In initiating the Inquiry, the Government had emphasised its 'free enterprise' objectives and the importance it attached to less government intervention rather than more. This motivated the Committee to emphasise competition which is efficient and stable, and to generally favour the discipline and processes of the market over regulation and control.

## V. CAMPBELL'S BLUEPRINT FOR AUSTRALIA'S FINANCIAL SYSTEM

Perhaps the central point advanced is that all interest rate controls should go. This means that banks would be able to pay interest on current deposits and market rates on time deposits of any maturity. We should not be surprised to see the reintroduction of bank charges for all accounts even though retention of minimum balances has permitted some removal in the past. Overdraft rates will no longer be weighted in favour of small borrowers; rationing, it would appear, will be entirely by market price. This increased competitive power of trading banks to attract funds will tend

## *A New Financial Revolution?*

to shift loan and housing finance back towards them. It will thus undercut the building societies and money market corporations, the latter through the elimination of their restricted advantage in offering interest on less than 30-day monies. In particular, the competitive advantages of the newly developed cash management trusts will be eroded.

This would seem to support the oligopolistic trading banks against their more competitive rivals though the latter to some extent are trading bank subsidiaries.

However, the banking arena is to be opened up considerably; other domestic banks and overseas banks being encouraged to seek Reserve Bank approval to fill that role provided they accord with the prudential standards laid down. Banks will still have to retain reserves with the Reserve Bank, continue to be the only group allowed to issue cheques, and be the sole operators in the foreign exchange markets. In this way, it is claimed, more competition will be induced into the banking area. Some of these banks would be specialist banks unlike the organisations we call banks now. Building societies might still be clearly recognisable as operating primarily on housing, but designated as 'banks'. Merchant banks even as 'banks' would continue to supply their traditional corporate expertise especially on international account. Many of these extra banks would not make much inroad into retail banking as such, or widespread branch banking in particular. The attractions of becoming 'banks' would arise first negatively as contemporary advantages are undercut, and second positively, as they seek to join the clearing system for cheques and participate directly in foreign exchange operations. The lender of last resort facility would be extended to them also so that investment in them will gain a higher credit rating from the public (with this higher rating perhaps offset to some degree by a decline in relative efficiency as the risks of failure come to appear smaller). Traditional rediscounting and lines of credit apart, the lender of last resort facility would not be available automatically. Such availability would depend on Reserve Bank judgement on the performance of a bank, and on its judgement of the adverse wider effects, stemming from the weakness or default of the bank. Thus exit would become the decision of a bureaucratic body - an interesting deviation from the traditional view of competition where no bureaucrat is installed as policeman. The door is increasingly open for the sort of political lobbying long associated with protection for manufacturing.

Presumably fresh entry into banking would have to proceed in step with the relaxation of interest rate controls, to

avoid unnecessary turbulence in financial flows. Some lessons might be drawn here from David Stockman's account of the first year of the Reagan administration.

In the foreign exchange market, the Committee wants to end the procedure whereby four wise men (drawn from senior officials from the Treasury, Reserve Bank, Department of Finance, and Department of Prime Minister and Cabinet) fix the exchange rate day-by-day, the so called 'flexible peg'. The Committee wishes to see the Reserve Bank merely modify the market rate by selling or buying foreign exchange as smoothing seems desirable. Further the Committee would relax all controls on the movement of funds between countries. It strongly favours the development of a forward market in foreign exchange, into which intervention should again be light, infrequent and for short periods (as with the spot market).

The Committee would remove the so-called 30/20 rule whereby organisations such as life assurance companies are required to hold 30% of their asset portfolios in government securities of which 20% would be Federal securities. This rule has been thought to help keep fixed interest rates down but seems to belong, if anything, to the days when the securities market was 'thin' - thickened since the inflationary seventies. The Committee thinks the rule itself may have made secondary markets thinner, and buyers less keen on Government paper.

Its recommended abolition of interest rate controls would suggest that mortgages will cost more to service as interest rates rise. The counterbalance to this comes through the greater availability of funds for housing which, says Campbell, should ensure that the really marginal borrower who has been forced, at least for a second mortgage, to solicitors, will now get access to housing finance more cheaply - though the intramarginal borrowers will have to pay more, but perhaps be able to move 'up-market' by borrowing more. It will be interesting to watch the political assimilation of this recommendation: the floating voters at elections are largely the intramarginal, not the marginal borrowers. A close analogy to the situation in the labour market is apparent here. People who have jobs seek at least inflation-proof pay rises; people who have no jobs continue to find themselves priced out of the market. There is no electoral grouping that increases the clout of the unemployed. Are we going to find that things are different for the first-time home-buyers? We may note that the unemployment problem is related to the height of the minimum wage in relation to the market wage; the housing

## *A New Financial Revolution?*

problem to the market interest rate relative to the height of the maximum mortgage borrowing rate.

### **Macroeconomic policy**

On macroeconomic policy, the Committee is brief. It wants to see the Reserve Bank use open market operations as the chief means of money control, though it would permit the retention of a variable ratio cash reserve device as an additional weapon. A near-market interest rate would be paid on required deposits with the Reserve Bank. Overall monetary policy in its view should be directed to monetary targeting with the specification and annual announcement of a range within which rates of monetary growth would lie. This would be renewed annually. At first glance, this appears monetarist in form, but in fact permits the authorities considerable discretion in practice. The Committee wants simultaneously to deny the authorities any significant role in fixing the exchange rates and in selecting levels of interest rates. Fine-tuning is then permitted, as Keynesians would hope, but only through quantitative controls, not through interest and price controls. On the 'rules versus discretion' debate, effectively the Committee is silent.

### **VI. SOME CRITICAL ISSUES**

Real income in Australia grows through the native wit, skill, and application of its citizens extending their activities through specialisation, production and exchange wherever rewarding opportunity is individually perceived. That is the message of Adam Smith; it presumably also fits in with the stated 'free enterprise' objectives of the Federal Government who commissioned the Report. (Their protectionist policies are at some odds with this interpretation). Money and finance clearly are important ingredients in such a process. It is the duty of public policy to oil the wheels of industry and thus facilitate the constant striving for growth in real income per head (broadly conceived to embrace the good life).

First and foremost the Government can assist by increasing the degree of trust accorded to monetary and financial instruments. Above all, a constraint on the power to create money is urgently required: the failure to secure this is the chief abuse of the last decade in most western societies including our own. It is pertinent to ask whether the Report sufficiently seizes upon this point. Rampant inflation will bring a free enterprise economy to its knees. Keynes has quoted Lenin to the effect that the best way to

destroy the capitalist system is to debauch the currency.<sup>9</sup> To this might be added that the most competitive system in the world for trading relationships can be instituted, but it can still be destroyed overnight with a sufficiently irresponsible handling of money by government. The only obvious defence against such action - apart from the delayed expression of wrath of an electorate - is the eternal vigilance and accountability of the Reserve Bank. The beneficial relaxation of credit control in the United Kingdom in 1971 was markedly nullified by the swollen budget deficits introduced then to reduce unemployment. We do not want to see a parallel here.

Has the Committee sufficiently clearly driven that point home? Has it sufficiently stressed the needs for built-in safeguards against subsequent abuse? Whereas the Federal Government stresses its free enterprise objectives, there are alternative governments to come, and safeguards are needed against abuse by any of them (whether or not they endorse free enterprise objectives so forcibly).

The Committee proffers the strategy of monetary targeting, but does not discuss the alternatives: competitive private monies or a remedy for the constitutional deficiencies in this area.<sup>10</sup> It seems strange that the Committee can reach conclusions in a highly controversial area without even discussing alternatives.

Turning to trading banks, the Committee advances the view that entry to this group has been unduly constrained in practice. It also feels that governmental ceilings on interest rates paid on deposit accounts have induced the proliferation of alternative institutions (for example, merchant banks, some of which are subsidiaries of trading banks) offering interest on deposits within the 30 day constraint imposed on trading banks and hence lending with advantage. Such activities have become very competitive; the recent expansion of cash management trusts has tended to drain funds from the trading banks and from other traditional lenders for personal finance and for housing. The lesson of the Campbell Committee - and it is possibly their main recommendation - is that interest rate controls should go. *Pari passu* more intermediaries should be encouraged gradually to become banks, the Reserve Bank having the say as to their credibility in that role. Foreign banks would be

<sup>9</sup> Keynes, J.M., *Economic Consequences of the Peace*, Macmillan, London, 1919, Chapter 6

<sup>10</sup> Brennan G., and Buchanan J.M., *The Power to Tax*, Cambridge, 1980

induced to come in within limits.

At first glance this seems very much in line with free enterprise objectives. But questions should be asked. In this as in many others, ceilings and controls have led to the development of institutions that bypass them. The effects of controls have been capitalised; is their removal, then, unequivocally to be desired? In practice, the intermediaries working outside the constraints have proved very competitive - a feature hardly noted of the trading banks. If 'banks' as defined enjoy at least some shelter from the Reserve Bank umbrella against bankruptcy, normally the ultimate assurance that competition is effective - will the competitive features of such intermediaries continue to operate?

Money depends upon trust; and IOUs were accepted early, in the form of overdrafts. This endorsement - be it noted - came privately: there was no necessity for state endorsement (convenient though it may be for notes and coin). The Committee speaks of the broadening range of IOUs and the necessity for prudential safeguards; it details the various types of scrutiny that should be exercised, notably by the Reserve Bank. Admittedly, private persons (individually and in groups) may act so as to restrain trade. But are the ordinary yet highly general processes of insurance and of the common law, unequal to the task of scrutiny? Is it not too easy for bureaucratic intervention to slip from use to abuse? After all when one buys a television set or a car one has only a limited protection through warranty or through general legal provisions. Purchase of personal services (for example electricians, teaching) relies enormously on trust, and enjoys little 'protection'. What makes finance unique? Presumably the answer would be the extent of the harm that can be inflicted on third parties. 'The obligation of building party walls, in order to prevent the communication of fire, is a violation of natural liberty, exactly of the same kind with the regulations of banking here proposed'.<sup>11</sup>

Smith did not rule out all prudential safeguards but he did set low limits fearing interference with personal liberty. Has the Committee adequately adhered to free enterprise objectives here?

### **Competitive neutrality**

The Committee attaches great importance to competitive neutrality, a term never really defined but clarified on pp. 1 and 522 of the Report. In essence the Committee wants

---

<sup>11</sup> Smith, *op. cit.* p. 424



every financial institution to have a fair go, and no undue privileges to be preserved for any category. They seem to have followed the terminology of the Wilson report. The justification for this is presumably the concern with the extent of the controls placed on specific financial institutions and instruments on the one hand, and with the inducements for the development of State-owned undertakings on the other. Unfortunately it is less clear that the Report advances its objective. Who can foresee the nature of new intermediaries? Competitive neutrality (if practicable) would preserve the status quo. There is a strong tendency in the Report to look at existing institutions to provide a criterion for assessing competitive conditions: these institutions are judged to be 'competitive' or not, as the case may be. But it is doubtful if operative meaning can be assigned to the term 'competitive neutrality'. (See Chapter 6 of this book for a further discussion of this issue.)

This leads to a further point. The Report looks critically at all forms of intervention and subsidy affecting the financial sector and says that in the interest of competitive efficiency they should go. Specific subventions and subsidies (if any) should come through the fiscal machine. There is no argument in economic theory that unequivocally supports such a conclusion. What economic theory says is that where monopoly or externality can be specifically traced to a good or service, the corrective should be applied at that point. Where disadvantaged groups are to be supported economists favour generally transferrable aids, such as income subsidies, rather than specific aids such as transport concessions or subsidised housing - but only if the funds made available do not distort basic decisions elsewhere. But if this conclusion is to be accepted in a world of high marginal tax income tax rates, the alternate costs must be weighed. Any needed correctives to the economy should be explicitly justified through the budgetary process - thus securing open parliamentary sanction. Although the Australian record on tariffs and quotas is in sharp contradistinction, there are nevertheless distinct political-economic advantages to be secured from such openness. Insofar as many of these interventions are longstanding and hence have been capitalised, their switch to the budget (even if this can be done cleanly) may involve so large a budgetary commitment that effective control of the money supply may be rendered much more difficult. Are the Committee, then, implicitly advocating a much more extensive pruning of government expenditure? Moreover, the Committee takes no note of the interconnection between sectors - for example, the impact of

some of their recommendations on the labour sector, must give rise to concern. A number of these financial subsidies have come to form part of the 'pay packet' and that brings into sharp focus the subject of pay relativities; there can also be implications for the self-employed.

Financial markets, where competition really reigns, may have few externalities, but much of the literature on the topic is actively preoccupied with the central aspect of marketable securities. The marginal contracts in any area have very thin markets indeed - cases where criteria of acceptance are hard to fulfil. Such markets in differentiated IOUs are far from competitive in the perfect competitive sense of that term. Today's 'marginal' borrowers may very easily be potentially tomorrow's most creative enterprises.

The Committee has done a good job in exposing these interventions and pointing to their direct costs in the financial sector. But even before the political economy of the proposed changes is fully thought through, there remain still the economic costs of introducing alternative arrangements. No economic theorem suggests that each little stable can be successfully cleaned out in isolation - by dumping all the unwanted paraphernalia in other stables. The case for arguing that the financial stable is the one to be kept most 'hygienic', with all costs borne by other sectors - needs stronger support than it receives.

This brings one to query the definition of competition that the Committee seems to embrace. Admittedly this varies throughout the *Report* - though there is a very strong doctrinal interpretation on page 1 and generally in Chapter 36, based on the competitive equilibrium model for a decentralised economy with its associated welfare recommendations. Quite apart from Hayek's strictures<sup>12</sup> one would have thought the work of Graaff and Arrow and Hahn would have raised doubts as to the serviceability of this theory as a standard of reference.<sup>13</sup>

It would seem far more in keeping with the real intent of the *Report* to use a less precise definition, one that argues that all freeing up in a system is advantageous. Freer entry and removal of controls can then be supported directly. Admittedly there may be costs of adjustment but it can be

<sup>12</sup> Hayek, F.A., 'The Meaning of Competition', in *Individualism and Economic Order*, University of Chicago, Chicago, 1948

<sup>13</sup> Graaff, J. de V., *Theoretical Welfare Economics*, Cambridge, 1957; Arrow, K.J., and Hahn, F.H., *General Competitive Analysis*, San Francisco, 1971

argued the ultimate effects will be favourable. The distributive effects in particular can be said to be ultimately beneficial: 'clogs to clogs' applying in (say) two generations instead of in three. No views on distributive justice necessarily imply that the balance should be rectified in this one generation whether or not poverty nets are provided. It is then up to governments to determine the adjustment processes to ease the lot of those who would suffer unduly. One could then look much more critically at the proposals in the Report for bureaucratic tightening, often introduced under the heading of prudential standards but suspiciously anti-competitive in content in terms of this alternative definition.

### State-run financial institutions

The Committee investigates State enterprises operating in the financial sector and, in sympathy with the Government's general objectives, is 'agin' them. But the steps by which it reaches its conclusions are surprising. It draws attention to the unfair advantages State banks enjoy because of their government backing in the eyes of the public - quite apart from any specific subsidies also received. Yet the argument that has always been made against state enterprise is that their incentive structure militates against their efficient working.

### ERRATUM

The last sentence of the first paragraph on page 19 should read:  
Or must controls be exercised so as not to give them preferential entitlement to customers either openly or by specific threats?  
customers either openly or by specific threats?

Again the Committee is anxious to measure the total sum of benefits received by State banks vis-a-vis their competitive rivals. Yet they have already admitted it is impossible to measure (as against non bank enterprises) the benefits accruing from the licence to bank. Does not the same difficulty arise here? And with which competitive bank is the comparison to be made - the young and the growing, the marginal, the steadily profitable, or some average? The case against State banks can be made quite directly without invoking these false objective criteria - or it cannot be made at all.

### VII. THE OBJECTS OF THIS BOOK

This book was designed to confront the substantive issues arising from the Report whether directly addressed within it

## *A New Financial Revolution?*

or not. Whatever the immediate political endorsement of the *Report*, many people and institutions will be profoundly affected by its findings. There seemed to be considerable advantages to be secured from inviting a group of experts unconnected with the day-to-day working of the local environment to appraise its content and its thrust, both in the light of their specialist knowledge and the working of related arrangements elsewhere. Indeed no author has given evidence or made submission to the Inquiry at any stage. This has both benefits and costs.

The costs are easily summarised. We have enlisted no advice on the specifics of organisation within superannuation, housing, life assurance or general insurance, or the nature of the business to be assigned to public autonomous institutions.

The benefits flow partly from a release from minutiae, and more certainly from an ability to take a long view covering the direction of development for financial intermediaries over a period extending at least to the turn of the century.

The contributors received the *Report* by special courier immediately on its release. They were asked to submit their contributions within four weeks. Postal delays did not help, but deadlines were otherwise adhered to. These are the first collected reactions of experts and the nature of the request made of them should be explicitly recognised and acknowledged.

Apart from the editor all contributors work abroad. One, John Bilson is an Australian, two others, Michael Parkin and Alan Prest have a good first-hand knowledge of Australia. Each author has a wide range of expertise in all the areas traversed by the *Report* and in allotment of topics some attempt has been made to draw on their specialist expertise also.

Michael Parkin was asked to give especial consideration to the macroeconomic scene while John Bilson was asked to look at international aspects with particular reference to movement of funds. Michael Parkin makes the point that anti-inflation policies will fail unless the public can be induced to believe in their persistence over time. To this end he considers that monetary policy should be outside Government's manipulative control. John Bilson argues that interdependence between countries will be enhanced if the Committee's recommendations for exchange rate and interest rate flexibility are carried into effect. He expects both rates to become more volatile in practice and concludes that domestic monetary measures may be needed to keep in check undue changes in inflationary pressures coming from

abroad. Yet Michael Parkin draws attention to the relative success of anti-inflationary policies in Germany and Switzerland, and more recently, Japan, whose international connections are at least as great as our own. The 'rules versus discretion' debate clearly has been too speedily dismissed by the Committee - much more investigation is needed before its recommendations in this area can be accepted.

Building on the Committee's recommendation that the Government should pay market interest rates on its indebtedness to the Reserve Bank and that the latter should pay near market rates of interest on moneys deposited with it by the trading banks and by Government, John Bilson suggests that there would be merits in terms of inflation control if the Reserve Bank were restructured in the form of a mutual fund. In his view this would contribute to the arrest of domestic inflation and to effective reduction in exchange rate and interest rate volatility, whilst treating all money-holders evenly.

Whereas John Bilson regards the payment of near-market interest rates on bank deposits with the Reserve Bank as at least a movement towards an explicit tax on the Authorities for generating expansion in the money supply, Tim Congdon views this recommendation with much apprehension. He claims that banks inevitably tend to hold cash as a precautionary reserve in fulfilling their basic role as safe depositories. They should not be paid to do this; such an interest payment is equivalent to a subsidy on that portion of their reserves which they would elect to hold anyway. Any reserve-deposit ratio requirement acts as an implicit tax, which banks will try and evade by disintermediation, as we know from experience. Should these reserves now receive a market rate of interest, there will be more inducement to hold reserves but also to grant more loans and overdrafts through realignment of their portfolios. Tim Congdon therefore opposes enforced reserve ratios, fixed or variable, and any payment of interest on reserves of any form.

Geoffrey Wood provides a very careful review of the circumstances in which market prices and market competition would prove defective in terms of efficiency and optimal allocation and concludes that none of these circumstances apply within the financial sector. As a specialist on banking, he examines critically the recommendation that entry of foreign banks be constrained and finds that this violates the Committee's own principle regarding competition in the area. He examines systematically the conditions under which banks should be permitted

## *A New Financial Revolution?*

to fail, a fundamental possibility in any competitive scheme, and supports deposit insurance protection precisely because he has some doubts as to whether the Reserve Bank would otherwise have sufficient nerve in practice to permit banks to die; whereas on other criteria he would reject deposit insurance.

Alan Prest examines in considerable detail the Committee's suggestions for fiscal reform in the financial domain. Notable amongst these are the desire for an integrated tax on persons and companies and for the rationalisation of fiscal treatment of life assurance companies, superannuation funds and building societies. He brings to light a number of serious imbalances in the suggestions and, as with Tim Congdon on monetary reform, draws attention to modifications introduced in other countries which would suggest the need for caution in design of changes here.

Each contributor expresses enthusiasm for the aims of the *Report* and the single minded thrust in that direction by the Campbell Committee. Each considers that Australia would benefit substantially in economic terms if its main recommendations were carried into practice. It will be noted that all discussion takes place within the *Report's* frame of reference and the view is advanced that in future this will happen as a matter of course in Australia. That by itself is an achievement. But the contributors also feel that the *Report* could be improved upon in certain respects and that constructive criticism is both what the Committee would hope for and also what would prove of most benefit to those who will determine the *Report's* implementation.

# 2

## **OFF TARGET ON MONETARY STABILISATION ISSUES**

An Assessment of the Macroeconomic  
Policy Aspects of the Campbell Report

Michael Parkin  
*University of Western Ontario*

Michael Parkin is Professor of Economics in the Department of Economics at the University of Western Ontario, Canada. He was educated at the University of Leicester, England and has taught at the Universities of Sheffield, Essex and Manchester. He has been a Visiting Scholar at the Reserve Bank of Australia, Visiting Fellow at the Hoover Institution, Stanford University and Visiting Professor, Brown University. He is the author of numerous research papers and co-editor of *Inflation in the United Kingdom*, *Inflation in the World Economy*, *Incomes Policy and Inflation* and *Inflation in Small Open Economies*. He is the author of *Modern Macroeconomics*.



## OFF TARGET ON MONETARY STABILISATION ISSUES

An Assessment of the Macroeconomic  
Policy Aspects of the Campbell Report

Michael Parkin

### I. INTRODUCTION

The Campbell Report has been hailed by those on the political and economic right as a magnificent document. It has been greeted at the other end of the spectrum with condemnation. The Report is vast in scope and to venture an across-the-board judgement requires much reflection and analysis. I am not going to offer an across-the-board judgement. Rather, I am going to focus on one narrow aspect of it, namely, its analysis of and recommendations on, macroeconomic stabilisation policy questions. Eight chapters of the Report (Chapters 1-8) deal directly with this matter. Chapters 1 and 2 deal in general terms with the role of government, the scope of government intervention in the economy in general and in the monetary sector in particular and with the role of the Reserve Bank. Chapters 3 to 6 deal with domestic aspects of stabilisation policy and Chapters 7 and 8 with external aspects. Other parts of the Report, especially Chapters 9 to 12 on public sector financing impinge on this issue but are not discussed directly in what follows.

I am not going to agree with either of the extreme views which have greeted the Report to date. As far as its recommendations on questions bearing on the efficiency of the financial sector are concerned, I agree with the judgement of the right - it is indeed a magnificent document which, if implemented, would lead to unimaginable gains to Australians in all income and wealth classes and in all fields of activity. As far as its recommendations on monetary stabilisation policy are concerned however, the Report is inadequate and even if implemented would make little difference to the macroeconomic stability of Australia.

The reasons why the Campbell Committee has done well on efficiency questions but badly on stabilisation issues, is not hard to find and furthermore not something for which they can properly be held responsible. Welfare economics and the theory of value on which it is based (microeconomics) is in a rather settled state. There is almost complete agreement amongst professional economists, at least at the level of principle, on what constitutes an appropriate policy approach. Differences in policy prescription reflect

## A New Financial Revolution?

differences in judgements about the quantitative importance of particular 'externalities' and it is possible for reasonable people to agree to differ on such matters. In such a situation it is hard for policymakers to diverge far from the academic consensus.

Monetary and business cycle theory (macroeconomics) is in a state of turmoil and confusion and is a source of disagreement, as great as at any time in its history. Economists differ not only in their judgements on the relevant magnitudes of particular parameters but in a much more fundamental sense. Different groups of scholars see the world through entirely different eyes. In such a situation policymakers, those who advise them, and commissions of inquiry set up to guide them, have little alternative but to be eclectic. Eclecticism is the practical response to academic disagreement. Bearing these matters in mind helps to understand why the *Campbell Report* is so good on allocational and efficiency matters and so bad on monetary stabilisation issues.

This paper goes on to substantiate this charge. It does not review the allocation efficiency issues and explain why the Campbell Committee is right in this area. As a result, this paper is unbalanced. My overall impression of the *Campbell Report* is a highly favourable one. The Committee should be congratulated on having done a superb job. It is the state of academic monetary and business cycle theory that is under attack, not the Committee *per se*.

This paper is organised as follows. First, the Campbell Committee's recommendations on monetary stabilisation policy are briefly summarised and the consensus view of the world that gives rise to these recommendations is described. That consensus view is attacked as being incapable of explaining our current and recent past predicament. An alternative - indeed in my view the **only alternative** - view of the world, the rational expectations view, is explained and its implications for the design and conduct of monetary policy outlined and contrasted with the recommendations of the Campbell Committee. Finally the Campbell Committee's recommendations are 'tested' by examining the policy performance of a country which in many respects already operates according to the procedures that the Campbell Committee is advocating. That country is Canada and its macroeconomic performance, under procedures close to those recommended by the Campbell Committee, points strongly to the conclusion that more is needed if monetary policy is to restore a stable macroeconomic environment.

## II. RECOMMENDATIONS ON MONETARY POLICY

The Committee treats as an axiom 'that the most efficient way to organise economic activity is through a competitive market system which is subject to a minimum of regulation and government intervention' (para. 1.1). That minimum of government intervention is not so small as to exclude the government from having a role in achieving macroeconomic stability. Specifically, in summarising what it sees as the 'proper role for government intervention' (para. 1.79) the Committee states that 'it is acknowledged that the implementation of monetary policy aimed at achieving such objectives as price stability and high employment requires a degree of government intervention in the financial system' (para. 1.85). Thus, the Committee is stating the consensus view that the proper role for monetary policy is the achievement of **both** real and nominal macroeconomic goals. In addition, the Committee makes it clear that it sees no case for a rule-governed policy, but favours maximum discretion. In the Committee's words 'it is clear that the need for government intervention and the appropriate methods of intervention change over time' (para. 1.89). In the light of some of the specific recommendations that follow (and which are discussed below) I read these introductory statements of principle by the Committee as being in line with the consensus view that monetary policy should be used to achieve **all** desirable macroeconomic goals and in a flexible and discretionary manner.

### **Reserve Bank and the consensus view**

Some content is given to this view when the role of the Reserve Bank is examined. Broadly, the Committee recommends that the existing institutional arrangements be maintained. In particular, the Reserve Bank should continue to be subservient to the Federal Government. Only the **financial dealings** (para. 2.82) between the Government and Reserve Bank are suggested as requiring modification. In view of the existing situation in which the Reserve Bank effectively implements the monetary policy of the Federal Government, this modification seems to be a minor one. The Committee's views on policy become even clearer when they come to state their recommendations concerning policy objectives and monetary targeting (Chapter 3). In the Committee's view, there should be a publicly announced intermediate target for monetary policy (para. 3.10). 'Such an approach to monetary targeting is in its view unduly

## **A New Financial Revolution?**

restrictive' (para. 3.10). The Committee does not however, favour what many who dislike a k percent rule do favour, namely, an interest rate target (para. 3.14). After a not very deep discussion the Committee recommends (para. 3.27) that 'the authorities should formulate, announce and seek to achieve a monetary target expressed in terms of a band of growth rates for a period of, say, one year. The authorities should examine alternatives to M3 as a target - including broader monetary and credit aggregates and "monetary base". Whatever target is chosen, other variables should be closely monitored'. It is hard to see this recommendation as being very different from what currently is done and as being any different at all from what the monetary policies of the Federal Reserve system are - where several alternative monetary aggregates are explicitly targeted. This 'look-at-everything' attitude is entirely consistent with the Committee's basic approach to macroeconomic stabilisation problems.

### **Monetary policy instruments**

In discussing the instruments of monetary policy the Committee rejects the use of direct controls on interest rates (para. 4.26), maturities (para. 4.29) and bank lending (para. 4.38). It advocates the use of open-market operations combined with a variable required reserve ratio (para. 4.44) and the payment of interest at near market rates on required reserves (para. 4.68). It does not favour the use of secondary reserve ratios (para. 4.52). To supplement reserve control and ensure sufficient flexibility the Committee sees the need for a last resort lending and rediscounting facility (para. 5.55).

### **External aspects**

As regards the external aspects of monetary policy the Committee wishes to see the existing institutional arrangements for fixing the exchange rate terminated (para. 7.13). 'The exchange rate should . . . be determined in the market and the authorities should deal in the market if they wish to promote a particular rate' (para. 7.13). 'The Committee does not view an absolutely free-float as a realistic option' (para. 7.16). Rather it wishes to see a system of what it calls 'lightly managed floating', with 'any official intervention in the foreign exchange market (apart from technical smoothing) [being] relatively light, infrequent and only for short periods' (para. 7.59). The Committee

wants to see a forward market established and wants to see exchange controls progressively dismantled (para. 8.35).

Many of these recommendations have a direct bearing upon the efficiency of the financial system in both its domestic and external dimensions, and from that perspective alone are clearly desirable reforms that, if implemented, would bring great welfare gains. I shall be taking issue below not with those aspects of these recommendations but with their implications for macroeconomic stability. Before that, let me go on to briefly describe the view of the world that gives rise to this set of recommendations.

### **Aggregate demand and supply**

Whilst it is never possible to ascribe views to a committee, it seems reasonable to conjecture that the committee consensus that produced these policy recommendations was one that is close to the mainstream neoclassical post-Keynesian view of macroeconomics that became fashionable in the 1960s. That view of the world is one that sees aggregate demand and aggregate supply as determining the level of real economic activity and the level of prices (or their rate of change). On the demand side many factors are at work. Total demand for goods and services in any particular period of time are influenced by fiscal policy, the money stock, the level of foreign economic activity, the exchange rate, and the state of entrepreneurial and consumer sentiment which influence the pace of investment and consumer durable spending. Of all these things that influence aggregate demand the ones that are potentially amenable to policy manipulation are the money supply and the exchange rate (though not independently of each other). Fiscal policy can also to some degree be manipulated but not as quickly and flexibly as can monetary policy. Fluctuations in aggregate demand arising from the noncontrollable sources can, and in the consensus view should, be offset by active adjustments either in the growth rate of the money stock or the exchange rate or both. The Committee comes down specifically on the side of wanting to leave the exchange rate to be determined by market forces and not be a variable of active policy targeting. Nevertheless, the Committee does want to use the money stock in a relatively flexible way. It wants to set a target growth rate for the money stock for one year ahead and at the same time keep an eye on a variety of other monetary magnitudes presumably with a view to varying the growth rate of the money stock, even within the year, if the message being obtained from those other magnitudes points in that direction.

## *A New Financial Revolution?*

On the supply side of the economy, the conventional view is that aggregate supply is influenced primarily by inflationary expectations and, crucially, that those expectations themselves are influenced by recent actual inflationary experience. Little can be done to change aggregate supply conditions by lowering inflationary expectations independently of lowering the actual rate of inflation by operating on the demand side of the economy. (There are those who take the view that expectations can be influenced directly by wage and price controls. The Committee does not address that matter but the indirect evidence from other aspects of the Committee's Report suggests that it would not be supportive of such a view.) It is this consensus view of aggregate supply and demand that leads to the elevation of both real and nominal macro-economic targets to the centre of the stage when discussing monetary policy. Too abrupt a tightening of monetary policy, it is believed, will give rise to a large drop in output and rise in unemployment with little or no reduction in inflation whilst too abrupt a loosening of monetary policy will produce an increase in inflation and a temporary boost to output and employment. It is the perceived need to balance employment and inflation considerations that leads to the view that monetary policy should be flexible, and should be targeted on the ultimate objectives of high employment and stable prices. Once the course of the money stock that is required to deliver these ultimate objectives has been determined, that money stock path should be delivered and should not be frustrated by undue external or domestic budgetary pressures. This can be achieved only by ensuring that the foreign exchange market and the government debt market do not get in the way of the required monetary policy. For this reason the separate pursuit of exchange rate and interest rate objectives has to be abandoned.

### **III. WHAT IS WRONG WITH THE CONSENSUS VIEW?**

What is wrong with the consensus view of the world? Put as is, most direct and blunt, the consensus view has failed a massive social experiment. It is often said that progress in monetary economics is slight and that we have learnt little that was not known in the early 19th century. That is very clearly false. In the 1950s, we knew a body of analysis known as Keynesian macroeconomic theory that revolutionised thinking and justified active policy stabilisation. By the early 1960s, we had improved on that Keynesian analysis to develop the neoclassical synthesis - the combination of

Keynesian theory of aggregate demand with the expectations augmented Phillips theory of aggregate supply. That theory guided the formation of policy through the 1960s and 1970s in pretty well every country in the western world (though with some important exceptions). The pursuit of policies suggested by that model - balancing inflation against unemployment and keeping an eye on a variety of monetary instruments - led to the explosion of inflation in the second half of the 1970s. Further, that inflation explosion was not associated with any better-than-average performance of unemployment or real output growth. Indeed, the real performance of the economy deteriorated (though of course not entirely because of the explosion of inflation). In recent years a variety of countries have adopted a policy of placing monetary growth on a decelerating course much like the Campbell Committee is recommending be pursued by Australia. Macroeconomic performance in almost every country both during the period of accelerating money growth in the late '60s and early to middle '70s and of decelerating money growth in recent years stands as a denial of the validity of the neoclassical synthesis as a predictive model. The inflation explosion of the 1970s simply has to be regarded by the neoclassical theory as an unfortunate 'exogenous' event (the blame for which is usually laid at the door of OPEC). The failure of inflation to moderate substantially in several countries where monetary deceleration has been pursued, also has to be explained as the unfortunate consequence of downward rigidity not in the level of, but rate of change of, money wages.

Overwhelming evidence that these 'alibis' for the neoclassical theory are incorrect is available from those few countries where policy has been conducted in a manner different from that suggested by this consensus view. Two countries stand out in the 1970s - West Germany and Switzerland - as examples of those unwilling to be swept along by the pursue-all-objectives, look-at-everything philosophy. In those two countries monetary policy was geared relentlessly at price stability (though occasionally the exchange rate intervened as a temporary alternative target) and the result was that despite OPEC, inflation never reached double digits and even by 1975 had already been virtually squeezed out of those two economies. Another country which has, at least after 1975, started pursuing relentless price stability with its monetary policies is Japan. Here it has been seen that the pursuit of a firm, highly stable, highly predictable and very hard solid monetary policy has delivered an amazing reduction in inflation.

## *A New Financial Revolution?*

These examples serve to show that the conventional alibis for the failure of the consensus model of macroeconomics cannot be taken seriously, for they fail to explain why it is that these three countries have had a macroeconomic performance substantially different from those in the rest of the western world.

## **IV. THE RATIONAL EXPECTATIONS ALTERNATIVE**

At any stage in the development of knowledge it is necessary to be cautious about recently advanced hypotheses. This lesson needs to be borne in mind when discussing the latest revolution in macroeconomics - the rational expectations revolution. We are still living through this process of rapid intellectual change and are not yet able completely to assess what is, and what is not, valid and durable. Much discredit has been brought to the rational expectations hypothesis as a result of it being mistaken for a particular theory of aggregate supply - the theory advanced in 1973 by Robert Lucas. It is now well understood, however, that the rational expectations hypothesis *per se* is neither classical nor Keynesian, monetarist nor fiscalist; indeed it is entirely neutral in its philosophical underpinnings but not neutral in its policy implications. The key idea, of course, is that people use information as efficiently as possible to form expectations about the future.

### **Future money growth**

In the context of a discussion of macroeconomic problems, the central variable whose expectations has to be formed is that of the future price level and therefore of the current inflation rate. This expectation critically affects the economy here and now. It has effects here and now because the expected rate of inflation is an intertemporal price that determines the demand for money here and now. If inflation is expected to be higher later (as a result of more rapid money growth later) then that expectation is translated into an immediate rise in the inflation rate. The mechanism whereby this happens is simple to explain and understand. If it is believed that five years down the line money growth is going to accelerate, thereby generating more inflation, it will be known that four years down the line less money should be held in order to avoid paying a predictable inflation tax. If less money is to be held four years down the line, a drop in the demand for money four years from now will be the equivalent of a rise in the supply of money four years from



now and therefore will generate a rise in the price level in four years, not in five years. Repeated application of this same argument leads immediately to the conclusion that an expectation of more rapid money growth at **any date in the future** produces a rise in the price level (and in the process a rise in the inflation rate) here and now. From this it follows that fluctuations in the state of expectations about future money growth produce fluctuations in the demand for money here and now and therefore produce fluctuations in prices here and now. These fluctuations will also, of course, be reflected in foreign exchange markets and, as a result of currency substitution, will lead to enhanced fluctuations in both exchange rates and prices. In short, uncertainty about **future money growth** produces instability in current macroeconomic magnitudes.

Future money growth expectations clearly are going to be heavily influenced by many of the matters touched on by the Campbell Committee. First, the place of the central bank and the influence of government to manipulate the central bank becomes a crucial matter in the formation of expectations of future money growth. Additionally, the state of the government's budget and the appearance or lack thereof of a sentiment to achieve a balance in the budget or a surplus will have a strong influence on expected future money growth. Variations in the state of the budget in a situation in which the government is in fact the monetary policy agent, will necessarily produce variations in the expected growth of the supply of money. Conversely, in a situation in which the central bank has been given some measure of independence from government, even though the state of the government's budget fluctuates and may from time to time be in serious deficit, fluctuations in expected future money growth will be moderated. This points to the first recommendation for monetary policy that is suggested by acceptance of the rational expectations hypothesis, namely that monetary policy should be made independent of fiscal policy. This could be done by making the central bank independent or it could be done by a legislated (with the status of a constitutional amendment) target growth rate for a monetary aggregate or with a legislated (again with the status of a constitutional amendment) declaration of the nominal price of some commodity or bundle of commodities. It cannot be done by leaving the government basically in charge of monetary policy, suggesting that an eye should be kept on all targets, and allowing the money growth target itself to be manipulated from year to year.

## *A New Financial Revolution?*

The second requirement implied by acceptance of the rational expectations hypothesis is that the incentives within the central bank (or other monetary policymaking institution) should be such as to ensure that the declared intermediate money growth objective be met and be expected to be met into the indefinite future. In the absence of such provisions it is hard to see how macroeconomic stability in general and price stability in particular are going to be restored. In a nutshell, what is required is a **monetary standard**. The world had such a standard until the abandonment of gold. It almost had such a standard when the so-called gold exchange system operated up to 1971. In the decade since then there has been no standard. It is as if we are trying to do business measuring lengths with rulers made of elastic! Viewed in this way, the preoccupation of the Campbell Committee with 'the need for a flexible approach' to monetary policy seems to be badly off target. What we need is the most inflexible approach we can invent. We need a rule that cannot and will not be broken and that binds politicians in such a way that, whatever their fiscal policy actions may be, they are not permitted to spill over into variations in the inflation tax, thereby generating expectations of future variations in inflation and destabilising the economy. This failure to discuss the need for a monetary standard and the alternative ways of achieving it, is the sense in which the Campbell Committee is 'off target on monetary stabilisation issues' (the title that I chose for this piece).

## **V. WHAT WE CAN LEARN FROM OVERSEAS EXPERIENCE**

I want to underline this conclusion by drawing attention to the macroeconomic policy and performance of a country which shares many of the features of Australia and which pursues a monetary policy not unlike that advocated by the Campbell Committee - Canada. In Canada flexible monetary targeting is pursued. Money growth has always stayed inside its announced target range (with too brief and clearly explicable exceptions) and that target money growth rate has been reduced successively from a 10-15% range in 1975 down to a 4-8% range at the present time. Throughout this period a money growth range was announced roughly for a year ahead and the range was lowered successively. The outcome of money growth was almost exactly on target, on the average, though considerably variable inside the target range. At the same time, the authorities behaved in exactly the way that the Campbell Committee would have the Reserve Bank of Australia operate in the foreign exchange

market, namely seeking to influence the exchange rate by direct operations and with relatively light intervention. The macroeconomic performance of Canada during this period cannot be described as anything but disastrous. Over that period the inflation rate has risen and interest rates have risen to unprecedented levels. Why has this happened? Of course, no one knows with any certainty. There is however, a plausible rationalisation in terms of the rational expectations hypothesis. Money growth in Canada has been highly erratic although inside the target range. Growth rates have varied from as much as +26% per annum to -5% per annum for periods of up to nine months. At the same time there has been a large and persisting government deficit. Further, it is well understood that the Bank of Canada, like the Reserve Bank of Australia, is an agency of the government and, at the end of the day, will pursue the policies required of it by the government. Since the government is behaving in a way that appears to indicate an expectation of continuing inflation in the range of 10-12% it is rational to expect that the government will, when the need arises, direct the Bank of Canada to pursue a monetary policy consistent with the achievement of that inflation expectation. Thus, it is rational for private agents to expect the continuation of high inflation even though at the present time monetary policy in Canada is tight. The consequence of this is that interest rates are high and the inflation rate remains high simply because, although monetary policy is currently tight the higher future inflationary expectation induces a higher velocity of circulation of money at the present time. Only by pursuing firm monetary policies and engendering an expectation that those firm monetary policies will be continued into the indefinite future can firm monetary policy bring about a reduction in inflation. It is this ingredient - the establishment of a monetary standard - that is missing in Canada and that will remain absent in Australia even if all the Campbell Committee recommendations are implemented.

# 3

## AUSTRALIAN FINANCIAL REFORM

Implications and Alternatives

John F. O. Bilson  
*University of Chicago*

**John F.O. Bilson** is an Associate Professor of International Economics at the University of Chicago's Graduate School of Business, and a Research Associate of the National Bureau of Economic Research. In 1980, he held the Robert Eckles Swain National Fellowship at the Hoover Institution and was a visiting Associate Professor of International Economics at the Graduate School of Business, Stanford University. Professor Bilson has previously been an economist in the Research Department of the International Monetary Fund, a consultant to the International Finance Division of the Board of Governors of the Federal Reserve System, and a member of the Economics Department of Northwestern University. He holds Bachelor of Economics and Master of Economics degrees from Monash University and a Doctor of Philosophy degree from the University of Chicago. Professor Bilson has published research on the economics of exchange rate determination, the application of rational expectations to economic policy, and the efficiency of financial markets.

## AUSTRALIAN FINANCIAL REFORM

Implications and Alternatives

John F. O. Bilson

### I. INTRODUCTION

When the Royal Commission into the Monetary and Banking System submitted its report in 1936, most of the Western economies were either still in, or emerging from, the Great Depression of the 1930s. Since the depression began with the collapse of the New York stock market in 1929, it was natural that inquiries into the causes of the depression should assign a major role to the inherent instability of financial markets and that recommendation based upon these reports would assign a major role to regulations designed to prevent bank failures. Interest rate ceilings, deposit insurance, reserve requirements, bank licensing and foreign exchange controls are but a few examples of regulations introduced in the pursuit of financial stability.

In the 1980s, it is fair to say that we still do not fully understand the causes of the Great Depression of the 1930s. There is, however, a strong presumption based upon the extensive research by Friedman and Schwartz<sup>1</sup> that the inappropriate monetary policies that were followed by the world's central banks contributed to both the length and the depth of the depression. Over time, the weight of evidence has shifted towards considering the depression as an extreme example of a failure of macroeconomic policy rather than as an example of the instability of unregulated financial markets. In particular, examples of 'destabilising speculation,' 'bandwagon psychology' and even multiplier effects have been hard to come by in the post-war period.

At the same time, economists have recognised that the financial regulations that were imposed in the interests of stability were unnecessary, inefficient, and often inequitable. In addition, the Keynesian notion of saving as a leakage from aggregate demand has given way to the supply side view of saving as the basis for growth. Hence in the *Campbell Report on the Australian Financial System*, we

<sup>1</sup> Friedman, M. and Schwartz, A.J., *A Monetary History of the United States*, Princeton University Press, Princeton, 1963.

## *A New Financial Revolution?*

observe a restatement of faith in private financial markets, a desire to encourage private saving, and a prescription that macroeconomic policy should be stable and predictable. In my mind, there is little doubt that the adoption of the recommendations of the Committee would result in a discrete improvement in the efficiency of the Australian financial system and an associated improvement in the well-being of the vast majority of Australian citizens.

In this review, I shall be primarily concerned with the implications of the Report for domestic and foreign owned corporations. Having expressed my overall enthusiasm for the Report in the previous paragraph, I find that I must base my discussion not on a comparison of the existing system with the proposed system, but upon a comparison of the proposed system with what I view to be an ideal system. Since the Report itself is utopian in flavor, such a comparison of theoretical systems appears to be appropriate. Since a great deal of political effort will be required to implement the proposals contained in the Report, it appears best not to start out in the wrong direction.

I begin, then, with a brief outline of those reforms that are of particular importance to the corporation. In the second and third sections, I shall discuss the implications of these reforms for the stability of financial markets and for the attraction of foreign investment into Australia. In the final section of the paper, I shall suggest some modifications and extensions to the Committee proposals that may help to give greater stability to the Australian financial market and to attract a greater volume of foreign direct investment.

## **II. THE WORLD ACCORDING TO THE COMMITTEE**

the Committee's main concern has been to promote a financial system that is **efficient, stable and competitive.** (p. xxvii)

the most efficient way to organise economic activity is through a competitive market system which is subject to a minimum of regulation and government intervention. (p. 1)

With these strong opening statements, the Committee introduces its liberal (in the classical, not the political, sense) view of the role of government in the financial markets. In brief, this view rests upon a belief that economic efficiency is best produced by competitive markets, that competitive

markets are the result of free entry into those markets, and that stability in competitive markets will arise from stable and predictable government behaviour in those markets. Before proceeding to the details, it may be worthwhile to review each of these foundations in general terms.

The efficiency of a competitive market is, of course, the fundamental contribution of Adam Smith to economic science. In the *Wealth of Nations*, Smith demonstrated that many isolated individuals, acting in their own self interest, will, as if by an invisible hand, produce a socially desirable outcome. Since Smith, there have been a number of attempts to describe the conditions under which the optimality of the competitive equilibrium will not arise. The two most important conditions which may prevent the social optimum from being attained are, of course, externalities and monopolistic practices. Externalities arise when there are social costs that are not included in the private calculus: if the costs of air pollution are not borne by the industrialist, he will produce more goods, and more pollution, than is socially optimal.

It is, indeed, difficult to find examples of externalities in competitive financial markets. There is the case of investment in human capital in which, because of the prohibition of slavery and the problem of moral hazard, we might expect that the return to human capital is too high relative to other investments, but this is more of a problem of educational policy rather than financial policy. More generally, the case for externalities in financial markets must be based on the assumption that market participants are irrational in some respects or that the government has better information than the private sector. We shall discuss the rationality and efficiency of the financial markets in the next section. As far as the differential information argument is concerned, the correct policy prescription, as the *Report* notes, is for the government to make the information available to the public rather than direct intervention in the market.

The issues of monopolies is very closely related to the issue of government intervention in the market. Clearly, there are many participants in the world financial market and it is unlikely that any group, including the OPEC cartel, would have sufficient market power to engage in monopolistic practices. These practices must consequently arise from policies which separate the local financial market from the competitive forces of the world market. These policies can, in general, only arise through the actions of the local



## A New Financial Revolution?

government. It appears, in fact, that regulations which were originally designed to protect the public against the financial institutions eventually lead to a situation where domestic financial institutions are protected against more efficient world financial institutions. As a result, local lenders are not permitted to earn the highest yield on their assets and local borrowers are often rationed. In the Australian case, the prohibitions against foreign bank entry into the domestic market, the prohibition against listing foreign stocks on local stock exchanges, and the system of exchange controls are all evidence of this activity. The Committee is certainly correct in recommending the abandonment of these controls. (See, for example, page xxviii).

It is also true that the regulation and control of the domestic banking system leads to the development of alternative financial intermediaries which compete with the traditional banks. As the *Report* notes, Australian banking regulations have had a role to play in the development of building societies, merchant banks, finance companies and credit unions. As these less-regulated institutions compete with the core banking system, a political demand arises that regulations be extended to the non-bank financial intermediaries. As this process has no determinate end, a more rational response must be to remove the regulations which inhibit the ability of the banks to compete in the financial markets.

The argument for financial deregulation is, then, based upon two fundamental premises. First, the evidence of significant and important externalities in financial markets is limited. Second, the regulatory process is itself a dynamic process in which the regulated institutions eventually learn how to adapt the regulations to their own uses. There is nothing sinister here; it is a simple consequence of the fact that the regulated institutions have the greatest incentive to modify and influence the regulations. In this regard, the most important use of regulation is to prevent entry into the financial market by foreign banks and by domestic non-bank financial intermediaries. One predictable implication of the *Report* then is that the Australian banking system will respond to the prospect of deregulation with muted enthusiasm.

Given free entry and free (unregulated) markets, the Committee contends that stability will result from a stable and predictable government policy. This view also has a long and respectable history. The idea is founded upon the belief that the demand arising from a large number of independent demands will be stable because of the tendency for random errors to cancel. This view of the world assumes the absence

of bandwagons leading to destabilising speculation; a view that will be explored below. It also sees the government as the only, or at least the major, large participant in the market. It is a view which does not pay much attention to the fact that Australia is a small country in a highly volatile world economy. In assessing this view, it will consequently be very important to consider the extent to which the policies suggested by the Committee insulate the Australian economy from disturbances originating in the rest of the world. If insulation is not complete, it may be necessary for the Australian authorities to adopt more activist policies than those suggested by the Committee. We must also put this issue aside for the present.

The monetary policies of the Committee include the targeting of a monetary aggregate rather than an interest rate or exchange rate policy, and recommendation that the financial dealings of the Reserve Bank should be placed on a more commercial basis. On the first point, the Committee recommends that:

the authorities should formulate, announce and seek to achieve a monetary target expressed in terms of a band of growth rates for a period of, say, one year. (p. 58)

Provisions related to the second point include:

- \* 'The Reserve Bank should pay a market interest rate on government account balances,' (p. 29)
- \* 'the Government should pay a market rate of interest in respect to its indebtedness to the Reserve Bank,' (p. 29)
- \* 'a near market interest rate should be paid on required deposits with the Reserve Bank.' (p. 78); and that
- \* 'the distribution of profits [between the Reserve Bank Reserve Fund and the Commonwealth should] be determined by the Board subject to the agreement of the Treasurer.' (p. 30)

The general idea, then, is that financial asset prices, including particularly interest rates and exchange rates, should be determined in the open market without a great deal of active intervention by the Reserve Bank. Instead, the Reserve Bank should establish a target growth rate for a monetary aggregate that is broadly consistent with the

## *A New Financial Revolution?*

maintenance of a stable price level. (see p. 52) Implicitly, these recommendations embody a view of the world in which interest rates predominantly reflect a stable 'real' rate of interest and an anticipated rate of inflation, so that stable prices also lead to stable interest rates, and in which exchange rates adjust so as to offset differences between the Australian inflation rate and the inflation rates of the major trading partners. In other words, stable money leads to stable prices, stable interest rates and stable exchange rates. It is, indeed, an appealing picture of the financial market.

As far as the commercial provisions of the monetary proposal are concerned, these provisions are designed to limit the competitive disadvantage imposed upon banks by non-interest bearing reserve requirements and to limit the ability of the government to finance deficits through monetary expansion and inflation. Along this general line, the recommendations for greater Reserve Bank autonomy may also lead to a smaller propensity for deficit financing through inflation. There are, however, a number of problems with the approach. While the provisions allow for the payment of interest on bank deposits at the Reserve Bank, there is no mechanism introduced for the payment of interest on currency held by the public. This is an important problem since, in Australia, currency in the hands of the public comprises 65 per cent of the monetary base. Hence even if the Government paid the market rate of interest to the Reserve Bank, and even if the Reserve Bank paid the market interest rate on bank deposits, the profits from the operation would still be large. Under the current system, there appears to be no mechanism in the long run for not remitting this revenue to the government and hence the provisions against long term deficit financing through monetary growth may be inadequate. In the final section of the paper, I shall suggest an alternative set of proposals for putting the Reserve Bank on a commercial basis which will allow the payment of interest on currency and will ensure that the government revenue from money growth is zero. At the present juncture, one might only note that the proposal does introduce a significant distortion into the financial system which would discourage the use of currency and encourage the use of deposit money.

It is now time to summarise this section of the review. In general, the Committee recommends the deregulation of Australian financial markets, the free market determination of interest rates and exchange rates, the payment of interest on deposits at the Reserve Bank, and the adoption of a target

for some monetary aggregate. In the next section of the paper, I shall discuss the implications of these recommendations for the Australian financial system.

### **III. AUSTRALIAN FINANCIAL MARKETS UNDER THE PROPOSED RECOMMENDATIONS**

Economics is not an experimental science, and we do not have laboratories in which the effects of changes in the economic environment on market behaviour can be gauged with any accuracy. We have seen that the Committee's objective is to create an Australian financial system that is efficient, competitive and stable and, in the previous section, I have reviewed some of the recommendations which, if adopted, are predicted to lead the system to the desired state. In this section, I shall review the evidence on the efficiency of financial markets from a small country viewpoint, and then discuss the implications of this evidence for the stability of financial markets.

To simplify matters, assume that there are only three financial markets in Australia - a bill market, a spot foreign exchange market, and a forward foreign exchange market. Instruments traded in the bill market may include certificates of deposit, government bonds, and Treasury Bills. From these instruments, we choose one instrument - say a three month Treasury Bill - that is equivalent, in terms of maturity and risk, to a US Treasury Bill. With a freely floating exchange rate, and an operational forward market, the relationship between the yield on the two financial instruments may be found from the interest rate parity condition.

This condition is based upon a simple arbitrage argument. Consider a US investor who is deciding whether to place  $X$  US dollars in either a US Treasury Bill or an Australian Treasury Bill. At the end of the holding period, the return on the US instrument is  $X(1+i)$ , where  $i$  is the nominal rate of interest in the United States. To place the US dollars in an Australian bill, the dollars must first be converted into Australian dollars in the spot currency market, then placed in the Australian bill, earning interest at a rate  $i^*$ , and the expected proceeds must be converted back into US dollars in the forward currency market. Since both strategies yield a certain end-of-period quantity of US dollars, the yield on the two investments should be the same if the financial markets are open and efficient. The interest rate parity condition then implies that

## A New Financial Revolution?

$$(1+i) = \frac{F}{S} (1+i^*) \quad (1)$$

where  $F$  and  $S$  represent the forward and spot exchange rates, expressed in units of US dollars per Australian dollars. For most purposes, it is more convenient to state the parity conditions in terms of the following approximation to equation (1):

$$i = i^* + \frac{F - S}{S}$$

where the forward premium or discount on the Australian dollar is represented by  $\frac{F - S}{S}$ .

Evidence from the recent episode of flexible exchange rates offers broad support for the interest rate parity condition. As an example, we might consider the rates quoted on Eurocurrency deposits at the end of November 1981. In Table I, the nominal interest rate on deposits denominated in different currencies are presented in the first column; in the second column, the forward premium or discount on the currencies is listed, and in the third column, the covered yields - the sum of the nominal yield and the forward premium or discount - are presented. From this small sample, it is obvious that nominal interest rates are tied together through forward premia and discounts. In the absence of capital controls, it is also likely that Australian interest rates would also be related to world interest rates through the interest rate parity condition.

From the point of view of the local financial market, the important lesson to be learnt from the interest rate parity relationship is that the adoption of a flexible exchange rate regime allows a country with open financial markets to choose its own interest rate. In other words, the flexible exchange rate regime insulates the interest rate because of the offsetting variation in the forward premium or discount. In the sample in Table I, nominal interest rates range from over 22 per cent per annum in Italy to 7 per cent per annum in Japan. The nominal interest rates themselves are a combination of real interest rates and the expected rate of inflation and, although most cross country differences are predominantly a reflection of anticipated inflation, it is the local real rate of interest which maintains equilibrium in the money market in the short run. The reason is that the other determinants of the demand for money - prices and real

income - do not adjust rapidly enough in the short run to act as a market clearing mechanism.

**TABLE I: THE INTEREST RATE PARITY CONDITION**

November 27, 1981.

CURRENCY YIELD	NOMINAL COVER	FORWARD YIELD	COVERED
US	12.12	0.00	12.12
Canada	15.38	- 3.54	11.84
England	14.94	- 2.66	12.28
Belgium	16.12	- 4.14	11.98
France	16.37	- 4.65	11.72
Germany (FR)	10.62	1.69	12.31
Italy	22.87	- 9.34	13.53
Netherlands	11.25	0.66	11.91
Switzerland	9.88	2.15	12.03
Japan	7.125	4.55	11.67
Mean	13.66	- 1.53	12.13
Standard Deviation	4.43	4.09	0.53

Source: Harris Bank Weekly Review, November 27, 1981. Yield data refer to three month Eurocurrency deposits.

The fact that interest rates are insulated by the flexible exchange rate is an essential component in the 'asset market' theory of exchange rate volatility.<sup>2</sup> To see this, consider the case in which there is a once and for all unanticipated increase in the demand for Australian dollars. Following standard monetary theory, the Australian interest rate must increase in order to clear the money market, but interest rate

<sup>2</sup> This exposition of the asset market approach is based upon Dornbusch, R., 'Expectations and Exchange Rate Dynamics', *Journal of Political Economy*, 84:6, December 1976, pp. 1161-76. For a review of recent developments in the asset market approach, see, Bilson, J.F.O., 'Recent Developments in Monetary Models of Exchange Rate Determination', *International Monetary Fund Staff Papers*, 26:2, June 1979, pp. 201-223, and Frenkel, J.A. and Mussa, M., 'The Efficiency of the Foreign Exchange Market and Measures of Turbulence,' *American Economic Review*, 70, May 1980, pp. 374-81.

## *A New Financial Revolution?*

parity implies that this increase in the local interest rate must be accompanied by a discount on the Australian dollar in the foreign exchange market. If the foreign exchange market is dominated by rational speculators - an assumption that we will explore below - the discount on the dollar must correspond to an anticipated depreciation of the Australian dollar relative to other currencies. This anticipated depreciation is brought about by an immediate appreciation; in simple terms, the spot price of foreign currency in terms of Australian dollars must immediately fall until the market expects that this price will increase at a sufficient rate to compensate for the interest rate differential. Hence the insulation of the interest rate is purchased at the expense of a volatile exchange rate.

The other important implication arising from the asset market approach is that exchange rate changes will not be closely associated with movements in differential inflation rates in the short run. Because prices adjust to economic conditions more gradually than asset prices, the short run appreciation of the Australian dollar predicted in the previous example will not be immediately reflected in a fall in the Australian price level relative to the world price level. Instead, the appreciation of the Australian dollar, accompanied by the increase in Australian interest rates, will gradually reduce the inflation rate through a number of channels. For exports denominated in Australian dollars, the higher foreign currency prices will result in a reduction in the demand for those products while, for exports denominated in foreign currencies, the reduction in Australian dollar export receipts will discourage supply. As far as imports are concerned (especially intermediate inputs denominated in US dollars - oil being the most important example) the appreciation of the Australian dollar will lower the local currency costs of these imports and reduce the overall cost of production. There will thus be downward pressure on prices in the intermediate run.

The 'failure' of the purchasing power parity condition is well documented in the recent literature on flexible exchange rates.<sup>3</sup> For a country anticipating the adoption of a flexible exchange rate, the lesson to be drawn from this evidence is that the commodity markets will not be insulated from world monetary conditions by the flexible exchange rate, and that,

---

<sup>3</sup> The recent evidence on the purchasing power parity condition is reviewed in Frenkel, J.A., 'The Collapse of Purchasing Power Parities During the 1970s', *European Economic Review*, 16, February 1981, pp. 145-65.

in fact, the tendency for exchange rates to 'overshoot' in order to clear the asset markets results in greater variability in competitiveness under a flexible exchange rate than under a fixed exchange rate. This is not an unimportant consideration in the Australian case where exports constitute approximately twenty per cent of GNP. Recent evidence presented by Jacob Frenkel suggests that the variance of the exchange rate may be three to six times the variance of relative prices on a monthly basis.<sup>4</sup>

To summarise, the recent evidence on the operating characteristics of flexible exchange rate systems suggests a quite different world from that described in Friedman's 'Case for Flexible Exchange Rates'.<sup>5</sup> In that article, Friedman suggested that the adoption of a flexible exchange rate allowed a small country to implement an independent monetary policy which would result in an independently determined inflation rate. Through the purchasing power parity condition, the exchange rate would then adjust in a gradual and stable manner to offset the difference between the inflation rates, and the interest rate would be determined by a stable real rate of interest and the expected rate of inflation. In this world, then, a stable domestic monetary policy and a flexible exchange rate would result in stable macroeconomic conditions.

In contrast, the asset market approach recognises that commodity markets are not perfectly integrated and that the exchange rate is determined by conditions in the local and world financial markets. From this presumption, the approach suggests that the exchange rate will be volatile and that it will not be closely related to relative prices. It also implies that the local commodity market will not be insulated from monetary developments in the rest of the world. Consider, for example, the tightening of US monetary policy under the Reagan administration. The immediate effect of this policy was an increase in US interest rates and a large increase in the foreign currency price of the US dollar. Since oil and other raw materials are invoiced in dollars, the US policy resulted in an increase in the local currency price of these inputs in the other countries, leading to upward pressure on costs and downward pressure on output and employment.

<sup>4</sup> Frenkel, J.A., 'Flexible Exchange Rates and the Role of "News": Lessons from the 1970s', *Journal of Political Economy*, 89:4, August 1981, pp. 665-705.

<sup>5</sup> in Friedman, M., *Essays in Positive Economics*, University of Chicago Press, Chicago, 1953.



## *A New Financial Revolution?*

Given the absence of insulation, it may be difficult for a small country like Australia to keep to a constant growth in monetary aggregates when the monetary policies of the large countries are being revised. In order to limit the adverse effects of a tight US monetary policy, many European countries have had to adopt contractionary monetary policies themselves. While this policy limits the change in the exchange rate, it also implies that the high US interest rates are exported to the co-operating countries. The choice consequently comes down to suffering a recession due to the exchange-rate-induced increase in the price of imported intermediate goods and the recession induced by high interest rates. The conclusion to be drawn from the current experience is that it may not be possible to choose between a fixed or a flexible exchange rate regime without a consideration of the monetary policies of the major countries.

In the *Report*, the Committee recommends that the Reserve Bank follow a stable money growth rate rule and that it allow interest rates and exchange rates to be determined in the market. On the basis of an analysis of the experience of other countries operating under similar conditions, I have suggested that the adoption of these recommendations would result in large and unpredictable movements in the exchange rate - mean absolute changes of approximately two per cent per month - and that these changes would have a considerable influence on the Australian terms of trade. In addition, such changes need not be the result of developments in the Australian financial markets, so that arguments that domestic financial markets are stable may not be important if foreign central banks are rapidly changing their monetary policies. In the final section of the paper, I shall suggest some alternative reforms which may help to overcome these problems with the Committee's proposals. Before turning to this topic, however, it will be useful to review some of the recent evidence on the efficiency of international financial markets.

### **IV. THE EFFICIENCY OF INTERNATIONAL FINANCIAL MARKETS**

The preceding discussion of the interest rate parity condition demonstrated that international financial markets are well arbitrated. In other words, there are few opportunities for risk-free profit arising from deviations from covered interest rate parity or currency arbitrage. There is however, a more difficult implication of efficient market theory relating to speculative arbitrage. Many commentators have suggested

that the volatility of exchange rates is not an important deterrent to trade and investment because this risk may be hedged by the purchase or sale of contracts in forward exchange. If the forward exchange rate is an unbiased forecast of the future spot exchange rate, then the expected cost of hedging foreign exchange risk is zero, apart from transaction costs. Given that exchange rates have been volatile, evidence that forward rates are unbiased forecasts of future spot rates would strongly support the Committee's non-interventionist position. However, if the evidence is against the hypothesis, there may be a role for the Reserve Bank as a stabilising speculator in the forward currency markets. Hence, in this section, we examine the efficiency of forward foreign exchange markets and discuss how departures from efficiency are related to the volatility of exchange rates and interest rates.

In order to test any hypothesis, a reasonable alternative hypothesis must be specified. According to the 'forward parity' theory described above, the forward rate is the best, unbiased forecast of the future spot rate. As an alternative hypothesis, we assume that the exchange rate follows a random walk, so that the best forecast of the future spot rate is the current spot rate and that, by implication, forward premia or discounts are unrelated to anticipated changes in the exchange rate.

To compare the two models, we construct the following composite forecast equation:

$$S_{t+1} = \beta F_t + (1-\beta) S_t + u_{t+1} \quad (3)$$

where  $u_{t+1}$  is a serially uncorrelated forecast error. According to the forward parity model, the weight given to the forward exchange rate,  $\beta$ , should not be significantly different from unity. On the other hand, if exchange rates do follow a random walk, then this weight should not be significantly different from zero.

Estimates of the  $\beta$  weight, based upon monthly data over the period from January 1975 to November 1980, for five major countries are presented below.<sup>6</sup> Standard errors are presented in brackets beneath the coefficients. Although the

<sup>6</sup> These estimates are taken from Bilson, J.F.O., 'Profitability and Stability in International Currency Markets', *NBER Working Paper*, 1981. In this paper, the relationship between the failure of the forward rate parity condition and the stability of the exchange rate is discussed and tested in more detail.

## A New Financial Revolution?

weights are not estimated with a great degree of precision, there is a notable tendency for the estimates to lie below the forward parity value of unity. In two cases, France and Japan, the estimates are significantly below unity and when the weight is constrained to be the same for all of the currencies, the estimated pooled weight is again significantly below unity at the five per cent significance level.

Currency	$\beta$ Weight
Canadian \$	-0.05 (0.66)
Pound Sterling	0.44 (0.54)
French Franc	0.39* (0.31)
Deutsche Mark	0.63 (0.49)
Japanese Yen	-0.81* (0.71)
Pooled	0.38* (0.21)

It would be wrong to interpret the failure of the forward parity condition as evidence that markets are not efficient, since these tests do not take account of the risk arising from foreign exchange speculation. The evidence is, however, important in assessing the stability of interest rates and exchange rates under a floating exchange rate system. Equation (3) may be re-written as

$$\frac{E(s_{t+1}) - s_t}{s_t} = \beta \left[ \frac{F_t - s_t}{s_t} \right] \quad (4)$$

where the term on the right hand side is the forward premium or discount on the currency. Taking 40% as a representative value of the  $\beta$  weight, the results suggest that the best forecast of the rate of change in the exchange rate is approximately 40 per cent of the forward premium.

Alternatively, the results are suggesting that the forward premium is roughly two and one half times as large as the rational expectation of the rate of change in the exchange rate. Since interest rate parity holds, the implication is that international differences in nominal interest rates will also be far greater than can be justified on the basis of exchange rate expectations. A risk averse speculator would have made money, on average, by borrowing in countries where interest rates are low and lending in countries where interest rates

are high. Within the terminology of the forward market, the implication is that one should sell short if the currency is at a premium in the forward market, and take a long position in currencies that are at a discount.

In the paper from which these results have been taken, I demonstrate that the failure of the forward parity condition to hold has increased the volatility of both the exchange rate and international interest rate differentials. Hence the natural tendency for volatile exchange rates arising out of the asset market approach is supplemented by additional volatility due to the failure of forward rate parity.

The policy implications of these results depend upon their presumed causes. If they simply reflect a lack of information, then the  $\beta$  weight may tend towards unity over time. However, if the results do reflect a risk premium, then it may be possible for Reserve Bank intervention in the forward currency market to be both profitable and stabilising in both the currency and financial markets. In order to implement the intervention strategy, it would be necessary for the Reserve Bank to announce an expected rate of change in the exchange rate and a rule for purchasing and selling in the forward markets based upon deviations of the forward premium or discount from that expected change.

All of the above suggests that the recommendations of the Committee would result in more volatile movements in Australian interest rates and exchange rates. Although there has not been any strong evidence that exchange rate volatility inhibits trade and investment, these characteristics of the flexible exchange rate system are probably not in line with Committee's concern for a stable financial system. One is left, then, with the problem of modifying the financial market recommendations in order to eliminate the problems discussed above.

#### **IV. AN ALTERNATIVE PROPOSAL FOR FINANCIAL REFORM<sup>7</sup>**

For the purpose of this discussion, the recommendations of the Campbell Committee may be summarised under three headings: deregulation of the financial markets, quantity targeting for monetary aggregates, and commercial reform of the Reserve Bank. Under the last heading, the payment and receipt of interest on the balance sheet items are the most

---

<sup>7</sup> This section is based upon Bilson, J.F.O., 'A Proposal for Monetary Reform', manuscript, University of Chicago, 1981.

important provisions. Although there are many economic benefits which would result from these reforms, the experience of other countries does suggest that the adoption of the recommendations would lead to greater instability in exchange rates and interest rates. Furthermore, the commercial reforms suggested for the Reserve Bank would not include payment of interest on currency, so that currency would be taxed relative to demand deposits and government revenue could still be created by money growth.

In suggesting an alternative, I would like to stay within the objectives and the approach of the Committee. I shall begin, then, with the commercial reform of the Reserve Bank, and shall retain the proposal that the Australian government should pay interest on its net indebtedness to the Reserve Bank. The modification will relate to the way in which this revenue is remitted to the holders of the currency.

The basic idea is that the Reserve Bank should follow the operating procedures of a mutual fund rather than of a bank. A mutual fund issues shares in exchange for dollars, and then uses the dollars to purchase assets. Let us consider the case in which the initial exchange rate between the shares issued by the Fund and the dollar is unity, and that the funds are invested in a bond yielding a return of 10 per cent per year. We also assume that the fund does not pay dividends, but holders of the shares may convert them back into dollars on demand. Hence, at the end of the year, the exchange rate would have risen to 1.1 dollars per share as interest was paid. In general terms, the exchange rate is set equal to ratio of the dollar value of the portfolio to the number of shares issues. In symbols:

$$P \left( \frac{\$}{\$} \right) = \frac{V(\$)}{M(\$)} \quad (5)$$

where  $P$  represents the price of the share,  $V$  is the dollar value of the portfolio, and  $M$  is the number of shares issued. This equation has two important characteristics. First, as mentioned above, as the value of the portfolio per share increases, the dollar price of a share will also increase. Second, as long as new shares are sold at the same price, the price of the share will be independent of the quantity of money.

Now consider the idea of turning the Reserve Bank into a mutual fund. The assets of the Reserve Bank can be divided into international reserve assets - predominantly gold and foreign exchange - and domestic credit instruments - predominantly government securities. The balance sheet identity may be written as :

$$S R + D = M \quad (6)$$

where  $S$  is the exchange rate, expressed in units of Australian dollars per US dollar,  $R$  is the US dollar value of the international reserve assets,  $D$  is the Australian dollar value of the domestic credit instruments, and  $M$  is the monetary base. Apart from contributions to the reserve fund, this identity is maintained at the present time by payment of Reserve Bank income to the government. The Committee has recommended that the revenue should be paid to the holders of deposits at the Reserve Bank, but it is unlikely that these payments would exhaust the revenue since currency is non-interest bearing and the interest on deposits at the Reserve Bank would be below the market rate.

The alternative, based upon the mutual fund model, would be to set the exchange rate at the rate which would maintain the identity. In other words, the Reserve Bank would stand willing to exchange Australian dollars for US dollars (or any other convertible currency) at the following rate

$$S = \frac{M - D}{R} \quad (7)$$

For practical purposes, this value would be the mid-point of a bid-ask spread of one or two per cent. Such a system might be called an equity standard, since the Australian dollar effectively becomes a non-dividend equity claim on the Reserve Bank's portfolio of assets.

The equity standard has a number of advantages over either a fixed or floating exchange rate regime. The first notable characteristic of equation (7) is that the exchange rate is independent of the quantity of money. If the demand for dollars increases, then commercial banks can sell government securities to the Reserve Bank in exchange for Australian dollars. This would result in an equal increase in  $M$  and  $D$  in equation (7) and the exchange rate would not change. Thus the equity standard is capable of responding to changes in the demand for money without causing inflation. Secondly, as interest is paid on the Reserve Bank holdings, the exchange rate would increase. Given the interest rate parity condition, the value of the Australian dollar in US dollars would increase at a rate that is approximately equal to the nominal rate of interest in the United States. However, because of operating costs and taxes paid to the government, the effective interest rate (in US units) would be probably two or three per cent below the US interest rate.

## *A New Financial Revolution?*

Again using interest rate parity, these estimates imply Australian interest rates of approximately two or three per cent. Finally, since all of the revenue is transmitted in the form of capital gains rather than dividends, both currency holdings and deposits at the Reserve Bank would bear the same rate of return. The Reserve Bank would not pay interest on deposits at the Bank, but the US dollar value of these deposits would increase at the rate of interest.

An equity standard would guarantee long term price stability in Australia. Over the post-war period, US interest rates have been approximately equal to the US expected inflation rate.<sup>8</sup> Hence increases in US prices would be offset by an appreciation of the Australian dollar so that the Australian dollar price of US goods would be stable over time. There is, of course, no reason why convertibility should only apply to the US dollar since equation (7) may be applied to any currency. Hence there will be a general tendency for the appreciation of the Australian dollar against any currency to reflect the nominal rate of interest, and hence the inflation rate, in that country.

Apart from the expected appreciation due to interest revenue, the exchange rate will also change due to unanticipated capital gains and losses on the portfolio. This is an important consideration in the Australian case, since the Reserve Bank portfolio includes a large quantity of gold. A fall in the US dollar price of gold will lower the dollar value of the Reserve Bank portfolio and require a depreciation of the Australian dollar. In addition, the dollar value of long term debt may change when interest rates change, thus leading to a further source of variability in the exchange rate.

Given that the Reserve Bank portfolio does include risky assets like gold and long term debt, the adoption of an equity standard based upon that portfolio could lead to unnecessary volatility in the exchange rate. It would be preferable, for the purposes of exchange rate and interest rate stability, to restructure the portfolio to include a greater variety of assets and to shorten the maturity of those assets.

This may indeed be the correct justification for an Australia Trust. The Committee was, to my mind correctly, unimpressed with the benefits of a government fund which would channel savings into equity investment. There are, however, a number of benefits that would accrue if the

---

<sup>8</sup> For evidence in this issue, see Fama, E.F., 'Short Term Interest rates as Predictors of Inflation', *American Economic Review*, 65, June 1975, pp. 269-82

Australian dollar was backed by a portfolio that included equity investments in Australian industries. If this portfolio was well diversified, the impact of any particular industry upon the exchange rate would not be great. However, suppose that there was a large economy-wide shock - for example, a large scale reduction in government expenditure leading to widespread unemployment and recession. In this case, the US dollar value of the shares held by the Reserve Bank in Australian corporations would fall and the Australian dollar would depreciate relative to the US dollar. In this case, the depreciation would lower the world currency prices of Australian exports and increase the Australian prices of imports, thus shifting demand towards Australian goods. In other words, Reserve Bank investments in Australian equity stocks, in conjunction with an equity standard, could lead to desirable counter-cyclical movements in the exchange rate.

There is, then, a possibility for an activist monetary policy under an equity standard. At one extreme, the Reserve Bank portfolio could be comprised entirely of low risk, short maturity, bonds. In this case, the Australian dollar would exhibit a steady, predictable appreciation against the US dollar at a rate that would be one or two per cent less than the US short term rate of interest. Australian interest rates would be stable at around one or two per cent. At the other extreme, the Reserve Bank portfolio could be based entirely on equity shares of Australian companies with cyclical earnings. Under this strategy, the Australian dollar would depreciate when the economy worsened and appreciate when the economy improved. The exact structure of the portfolio would be based upon political and economic considerations.

Macroeconomic disturbances occur in both financial markets and commodity and labor markets. The most important type of financial market disturbance is a shift in liquidity preference between interest bearing assets and money. Under the equity standard, these shifts would be simply absorbed by the natural expansion or contraction of the money supply. As far as the real disturbances are concerned, countercyclical movements in the exchange rate can be created which would partly offset the impact of these disturbances. These features of the equity standard are not shared by either the fixed or the floating exchange rate systems.



## V. CONCLUSIONS

We live in an interdependent world in which all countries must compete for the available stock of financial resources. If a national government imposes regulations and constraints which reduces the return on assets held within its borders, those assets will simply move to another location. The costs of unnecessary regulations are consequently high. On the other hand, the benefits arising from the creation of a more hospitable environment are also very great. For the international investor, Australia offers vast possibilities for investment and a stable political climate. If these natural assets could be combined with an active, efficient and open financial system, there is little doubt that the volume of foreign investment in Australia would increase. This investment would in turn lead to higher real wages and an increase in the real value of national wealth.

The Campbell Committee has accomplished a significant task in specifying the most important distortions in the Australian financial system. The adoption of the Committee's recommendations would make the Australian financial system a showplace for enlightened economic policy in the same way that Hong Kong is a showplace of free trade. The proposed system does, however, imply that interest rates and exchange rates would be fairly volatile. This is really an unnecessary adjunct to the general emphasis on financial deregulation. In this paper, I have attempted to demonstrate that a change in the operating procedures of the Reserve Bank towards the adoption of an equity standard would offer further welfare gains to the society and would offer a method of controlling the volatility of financial asset prices in an unregulated market.

# 4

## **COMPETITION, INNOVATION, CONSUMER PROTECTION AND THE ROLE OF THE MARKET**

The Philosophy of the Campbell Report

Geoffrey E. Wood  
*City University*

**Geoffrey E. Wood** is currently Senior Lecturer in the Centre for Banking and International Finance at The City University, London. A graduate of Aberdeen and Essex Universities, he has taught previously at the University of Warwick, been a visiting Economist at the Bank of England, and visiting scholar at the Federal Reserve Bank of St Louis, USA. He has published articles in, among other journals, *American Economic Review*; *Journal of Money, Credit and Banking*; *European Economic Review*; and the *Journal of International Economics*. He is co-author of *Financing Procedures of UK Foreign Trade*, and co-editor of *Monetary Targets; Exchange Rate Policy*; and *Monetarism in the UK*.

## COMPETITION, INNOVATION, CONSUMER PROTECTION AND THE ROLE OF THE MARKET

The Philosophy of the Campbell Report

Geoffrey E. Wood

### I. INTRODUCTION

Throughout the *Report* of the Campbell Committee there is consistently expressed belief in the desirability of allowing the free working of competitive markets. This belief is particularly strongly expressed in those sections of the *Report* - Chapters 18-22, 23-25, and 32-33 - which respectively deal with the 'Protection of Investors and Borrowers', 'Participation in the Financial System', and 'Competitive Structure'.

First considered here is whether such belief is justified. Next, the connection between competition in financial markets and the effectiveness of monetary control is considered; this is an important issue, somewhat neglected in the *Campbell Report*. Then the reasons which Governments can have for intervening in markets are set out, and it is considered whether any of these apply to the financial markets. That done, the main theme of the *Campbell Committee Report* will have been appraised and the ground prepared for a discussion of some of the details of the *Report's* recommendations.

### II. COMPETITION IN BANKING?

In an industry, competition can be expected to promote efficiency. Efficiency, it should be stressed, has two connected but distinct meanings in economics. First, there is what is called **technical (or production) efficiency**. By technical efficiency is meant obtaining any given output with the least cost combination of inputs - or, alternatively expressed, getting the maximum possible output from a given set of inputs. That plainly is desirable. If firms are not doing that, then resources are being wasted - more, either of that firm's output or some other, could be produced with the amount of resources already in use. (Or of course, the same could be produced and less resources used up.)

The second kind of efficiency is **economic efficiency**. By this is meant that the price of a good in the market is equal to the marginal cost of producing it - the addition to total costs which results from producing an additional unit of the

## A New Financial Revolution?

good. It is desirable that price equal marginal cost because this ensures that individuals are having to pay for the good what the resources involved in producing it could earn elsewhere. If individuals are paying that, then they are paying what the resources used are worth to society.

How will competition produce these two desirable results? Competition will produce technical efficiency by driving out of business those firms which are not, or do not become, technically efficient; since other firms will be able to do whatever they are doing more cheaply. Economic efficiency will be produced by a similar route. If goods can only be produced at a cost in resources of more than the goods will sell for, these goods will disappear from production; while production of them will expand if more will be paid for them than the resources can earn elsewhere. In summary, competition ensures that the best use is made of available resources so what people want is produced as cheaply as possible.<sup>1</sup>

There are, however, some qualifications to this generally applicable conclusion. In some circumstances, competition working via the price system does not produce this desirable outcome. The price system is said to 'fail' when there is a divergence between the private costs or benefits and the social costs or benefits - between the cost or benefit to society.<sup>2</sup>

This kind of failure can be broken down into three categories - externality, including paternalism as a special case, increasing returns, and public goods. (Income distribution can produce an output pattern we do not approve of even though it is being efficiently produced; this is not a case of market failure, but of our disapproval of the efficiently produced output of the market, and is touched on below).

### Externality

One criticism of markets, and of the prices they reveal, which has been made for some decades is that buyers and

<sup>1</sup> An extended discussion of these issues can be found in, e.g., Samuelson, P.A., *Foundation of Economic Analysis*, Cambridge, Harvard University Press, 1947, Chapter 8; Bator, F.M., 'The Simple Analytics of Welfare Maximisation', *American Economic Review*, 1957, pp. 22-59; and Koopmans, T.C., 'The Efficient Allocation of Resources', *Econometrica*, 1951, pp. 455-465.

<sup>2</sup> An extensive and thorough analysis of the sources of 'market failure' is contained in 'The Anatomy of Market Failure', Bator, F.M., *Quarterly Journal of Economics*, 1958.

sellers who trade goods can create costs or benefits (externalities) for third parties not involved in the exchange. Under these circumstances the market 'fails'. It generates excessive production of goods (or services) for which the costs imposed on third parties cannot be compensated, and insufficient of these goods that yield benefits to others who are not party to the contract. From this observation follow both implications and policy recommendations. The implication important in the present context is that in the presence of externalities, market prices are a poor - and quite conceivably misleading - guide to resource allocation. The policy recommendation has often been that government intervention is beneficial - whether by levying taxes or providing subsidies to 'correct' the market, or by actively replacing the market.

This policy recommendation would have been the almost unanimous recommendation of economists after Pigou's<sup>3</sup> analysis of this issue, and before Coase's.<sup>4</sup> Most economists would have suggested, in the case of a negative externality (in production, for example) that we should either:

- (a) make the causer of the externality liable for the damage; or
- (b) place a tax, on the the causer of the damage equal to the marginal value of the damage he caused; or
- (c) exclude the activity from areas where its execution would harm others.

But since Coase it has been recognised that the interdependence is mutual. If A harms B by acting, B harms A by preventing his action. Which harm should be prevented? Surely the question is, which is valued more highly? In other words, when there is an externality, there is an unexploited gain from trade. If the externality were internalised to the market system, it would be priced and paid for.

These externalities generally fail to be internalised because of transaction costs. These can arise as a consequence of:

- (a) the inadequate specification of property rights; or
- (b) the nature of the externality; or
- (c) the inadequacy of the institutions.

<sup>3</sup> Pigou, A.C., *The Economics of Welfare*, Macmillan, 1920.

<sup>4</sup> Coase, R.H., 'The Problem of Social Cost', *Journal of Law and Economics*, October 1960.

## *A New Financial Revolution?*

In some cases, the externality arises only because the property right has, because of historical accident, not been defined. Define it, and the problem can be solved because there can then be market transactions in that property.

A second possibility is that individuals simply do not know the effects of the externality - for example, there can be disagreement about the effects on marine life of polluting a river. This disagreement prevents individuals from striking a bargain - and is of itself often evidence that the externality is not really a problem for society, but just a piece of special pleading by an interest group.

Third is the possibility that so many individuals are involved, each one to such a small extent, that transaction costs prevent bargains being struck. And last, institutions may impose transaction costs - the cost of going to law, for example.

In all those cases the price system does not produce satisfactory resource-allocating, marginal-value-measuring, prices because of constraints on its action.

### **Paternalism**

Paternalism is closely related to externality. The distinction is, indeed, only that in the case of an externality the well-being of a third party is affected via some physical impact on him or his surroundings, while in the case of paternalism the impact on well-being occurs without the physical intermediary. From that viewpoint the difference is trivial. Here, too, prices do not fully reveal preferences, since the fact that A feels better because B does something is not reflected in prices. But here too, a solution via the price system is available. A can give income to B, give goods to B, or subsidise the activity in which he wishes B to engage. The last of those is the one which is efficient, in that it shifts prices so as to encourage B to do what A wants, and A can precisely tailor the subsidy so as to maximise his well-being.

### **Increasing Returns**

There are increasing returns when to (say) double output one must less than double inputs. The situation here is paradoxical. Equating price to marginal cost by a producer allocates resources efficiently - he is charging what the good costs, and consumers are paying the opportunity cost of producing that good. But the producer would be making losses, because marginal cost (price) would be less than his average cost per unit. Prices allocate resources efficiently, but firms make losses.

What happens? Usually the problem is in fact not in this pure form; usually returns increase initially, and then decrease, and the problem is that economies of scale are such that the industry is dominated, or consists of, a very small number of firms and is therefore not competitive.

In that case costs are no longer equated to price but are less than price - and society would therefore like more of the good to be produced. The firms cannot sensibly be broken up; by the nature of their cost functions they would come together again. Laws can be passed in an attempt to deal with this, 'ordering' firms to behave 'as if' they were in a competitive industry, but it is doubtful how successful this is.

### Public goods

A good is a public good when one individual's consumption of it does not reduce the amount of it available to others. Such goods are, clearly, very rare. (Some goods approximate to that definition at first glance, but, as has been argued in the externalities literature, cease to be public goods upon a redefinition of property rights). Pure public goods clearly present a problem for the price system. If non-paying individuals cannot be **excluded** from consumption, then **no-one** will pay, and the good will not be produced even if many people are willing to pay for it if paying were the only way by which they could obtain it. (If non-paying individuals can be excluded, then the good could be produced; but exclusion would clearly be inefficient, in that many people could receive the benefit without affecting others' well-being, but are not allowed to). Such goods can only be provided by government funding them by taxation or borrowing, or by firms (or individuals) providing them charitably. The price system just does not yield prices for such goods, because individuals have no incentive to - and indeed cannot - exchange such goods among themselves.

Do any of these impediments to the working of the price system apply to the financial system? It is hard to see that any does. No-one has argued that banking or the provision of other financial services causes harmful externalities, or has beneficial spill-over effects for those who do not use the system. Paternalism is clearly not relevant here, and nor is the problem of public goods. There may be increasing returns in banking over a range of output. But many countries - certainly the USA and also many small European countries (not the UK because of a government protected cartel) support vigorously competitive banking systems. Hence increasing returns in banking did not appear to prevail



## *A New Financial Revolution?*

over a range of output sufficiently extensive to make a competitive banking system impracticable. It therefore appears that the case for competition in banking, and in the provision of all other financial services is as strong as it is for competition in any other industry. This certainly supports the main conclusion of the *Campbell Report*.<sup>5</sup>

### III. IMPLICATIONS OF COMPETITION IN BANKING

Although the general case for competition is strong it should be recognised that banking is a very special industry. The banking sector is essential to the working of a modern money-using economy. For that reason, bank failure can have dramatic economy-wide repercussions. An example is the Great Depression in the USA. This was certainly exacerbated by the bank failures which accompanied it.

Yet, as argued above, competition must allow for the possibility of firms entering and leaving the industry. There must be freedom of entry and exit. The *Campbell Report* recognises this; it favours liberalisation of entry conditions to banking, and frequently refers to the desirability of allowing orderly departures. How can the latter be achieved? And is allowing banking competition, removing the cushion of monopoly profits, more likely to lead to bank failures?

What would constitute an orderly departure? Plainly a business voluntarily deciding to leave the industry, and steadily running down its business, or transferring its banking business to another firm, would represent an orderly departure. Banks should, however, also be allowed to fail; if they are not, there is no discipline on management such as to produce either responsibility or even competence. There is a strong case for bank failure, not because bank failures are desirable but because the alternative is undesirable. It is, however, essential that such failures can occur without bringing down the rest of the financial system. How this can be done was described, in the last years of the 19th century, by Walter Bagehot.<sup>6</sup> If a bank is failing, the central bank should lend freely to the markets, buying whatever paper is offered to it so as to support other institutions in the wake of the failure - but, as Bagehot stressed, the central bank should not

<sup>5</sup> The case for competition in banking, both in general and in particular in the UK context, is set out in some detail in Griffiths, Brian, *Competition in Banking*, Hobart Paper No. 52, Institute of Economic Affairs, London, 1970.

<sup>6</sup> He did this in his classic *Lombard Street*, Kegan Paul, London, 1873.

attempt to support a fundamentally unsound institution. This can be done - in the USA the Federal Reserve System has acted in that way twice in recent years. Orderly exit is possible.

A fear sometimes expressed, despite this, is that competition will make failure more likely. It is sometimes argued that as banks compete for business they will undertake more risky loans, and have narrower spreads between deposit and lending rates, until they resort to unsound banking practices and consequently run the risk of insolvency. A most detailed test of this hypothesis has been carried out by George J. Bernston.<sup>7</sup> He investigated whether there was any systematic relationship between the interest rate paid on bank deposits and the returns on banks' investments, and the interest rate on deposits and the rate of bank failure. Neither set of results bore out the fear that competition would increase the riskiness of banking. Competition did not make banks more rash or more prone to failure. Hence the general case for competition in industry need not be modified in the case of banking - or at least, should not be modified by consideration of the special nature of one of the banking systems' products', the facilitation of transactions.

That does, however, leave undecided the questions of how free entry to banking should be, the consequences bank failure should be allowed to have for depositors, and how banking competition may interact with monetary control.

### Entry to banking

The Campbell Report is concerned with two aspects of entry to banking. These are whether foreign banks should be allowed to enter the Australian system, and how to ensure that the individuals who run banks are 'proper individuals' in that role. On these two issues, the report is less clear-cut than it could be. Why should foreign banks not enter as freely as domestic ones? Two possible reasons can be identified. One is that these banks 'may not be run in the interests of the home country'. This is a possible danger, but not in a competitive banking system. The reason such a possibility is not a danger in a competitive system is that in such a system no bank works for the sake of the economy. They all must work for profit or go out of business, and the way they make profits is to provide, as cheaply as possible, what their cus-

<sup>7</sup> Bernston, G.J., 'Interest Rates on Bank Deposits and Bank Investment Behaviour', *Journal of Political Economy*, October 1964.

tomers want. Foreign banks could conceivably pose a threat in an uncompetitive system - but in a competitive system which allows free entry and exit they can pose no such threat.

That is not to say that there are no additional complications ensuing from the presence of foreign banks. Who would be responsible if a foreign commercial bank, whether associated with some foreign financial institution or not, failed, would have to be resolved. But as the Campbell Report implies, the solution found for this does not much matter so long as a clear solution is actually found in advance of any problems.

In view of this, why is the Committee so cautious about allowing foreign banks free entry? The main reason seems to be the fear that they quickly would overwhelm potential domestic entrants to the industry. It is nowhere argued in the Report, however, why this would happen, why it would matter if it did, or whether some form of protection - essentially by non-tariff barriers - is the best way to prevent it.<sup>8</sup> Perhaps the Committee reached its conclusion at this point by considering what is likely to prove politically acceptable. This is hard to judge, particularly for a foreigner many miles away. But it does raise a question frequently confronted by economists who advise on policy. Should they advise what they think to be best, or should they advise the best course they think acceptable? The present author's inclination is to the former course, and to leave politicians to judge political acceptability; but the choice is not an easy one, and the Campbell Committee cannot be censured too strongly for the choice they appear to have made. (The effect of foreign banks on monetary control is taken up below.)

There is a similar fuzziness in the Report's position on new domestic banks setting up in business. It seems to be concerned that there be 'management of an acceptable quality'. Such woolly phrases are dangerous, giving immense and discretionary power to regulators. Acceptable to whom, and by what criteria?

---

<sup>8</sup> There is an extensive literature in international economics which demonstrates that barriers to trade whether by tariffs or other means, are not the best way to protect domestic industry from foreign competition. See in particular Bhagwati, J. and Ramaswami, V.S., 'Domestic Distortions, Tariffs and the Theory of the Optimum Subsidy', *Journal of Political Economy*, February 1963, pp. 48-50, and Wood, G.E., 'Senile Industry Protection', *Southern Economic Journal*, January 1975.

The same laws should apply to banks as apply to other companies. Undischarged bankrupts are usually excluded from directorships; and nor would it be harmful to compel all companies to publish the previous business experience of their directors and senior managers. Beyond that, there is no reason to have different standards for banks and other firms - particularly when it is clear that banks are to be allowed to fail.

### Depositor protection

The Committee considered whether there should be some scheme for the protection of depositors, such as the Federal Deposit Insurance Corporation in the USA, which would ensure that if a financial institution failed, depositors with deposits below a certain amount should be protected. This would provide no disincentive to prudent management. It would, however, be a disincentive to customers choosing their banks carefully. It would thus make life easier for incompetent or inefficient management. Further, why should such protection be provided for depositors? Such protection is not provided to purchasers of other goods or services, and it is not costless to provide. There would be a charge, either to general taxation or on the industry. The argument for protection of bank depositors must rest on arguments such as unequal knowledge, and the inability of small transactors to gain knowledge of the banking system. Everyone buys many packets of washing-powder in a life time, and not much is lost if one brand proves unsatisfactory; but the consequences to individuals of one bank proving unsatisfactory could be disastrous. Even then it is not usual to give such protection to purchases of say, houses, to which rather similar arguments apply. The case for deposit insurance is not a strong one - except on one point. If deposits are insured, regulators are more likely to allow banks to fail - and that is socially desirable.<sup>9</sup> Hence it may be concluded, albeit tentatively, that there is a case for deposit insurance. The case is, paradoxically, that it makes bank failures more likely.

<sup>9</sup> To find these arguments developed in detail, see Bernston, G.J., Discussion of a paper by Joseph W. Barr, in 'Policies for a More Competitive Financial System', Federal Reserve Bank of Boston, Conference Series No. 8, 1972.

### Competition and monetary control

The structure of the monetary system cannot be discussed apart from its effects on the conduct of monetary policy. One product of the banking system, bank deposits, is a substantial proportion of the money supply. A UK perspective on this issue is particularly useful. The UK does not have a competitive banking system; it is dominated by a small number of large banks, there are many administered interest rates, and entry into retail banking is difficult, in good part because of the control the existing retail banks have over the cheque clearing system. (The Campbell Report's recommendation that the cheque clearing system be independent of the banks is therefore very wise; indeed, the adoption of the recommendation is a prerequisite to a competitive banking system).

The UK experience with monetary control has not been successful. Monetary growth has persistently grossly exceeded both the targets set by the monetary authorities, and a rate consistent with price stability. Efforts at control have largely been exercised through rationing and other anti-competitive schemes, and have failed consistently, and by consistently large amounts.

One example of how the uncompetitive nature of the system has caused control problems was the phenomenon known as 'round tripping'. Because banks move their base lending rates in collusion rather than having them market determined, it was possible for them to lag behind rapidly changing market rates. Sometimes it became profitable for prime customers to borrow from banks just to on-lend in money markets. Under such conditions, monetary growth exploded. Of course, these interest differentials did not last long, and when they reversed so did the 'round tripping'. Nonetheless, the short bursts of money growth were harmful to the economy, simply because it was impossible to determine what the trend of monetary growth actually was. Further, it led to the introduction of a device, a limit on the growth of certain categories of bank deposit, which actually froze individual banks' market shares.<sup>18</sup>

In contrast, a system where the banks compete among themselves for a stock or reserve assets, whose supply is

<sup>18</sup> For further details on this, see Griffiths, B., 'The Reform of Monetary Control in the United Kingdom', *Annual Monetary Review*, No. 1, 1979, of the Centre for Banking and International Finance, The City University, London.

limited by the central bank and holdings of which would be essential before the bank could do any lending, would work well within a competitive system - essentially because it relies on prices to allocate the reserve assets to those who can put them to the most productive use.<sup>11</sup> The presence of foreign-owned banks in the domestic financial system does not affect this conclusion in any way. They, just like domestic banks, would have to acquire the reserve asset before they could do business in the domestic currency.

There is a most happy coincidence of interests between the desire for a competitive banking system and the desire for effective monetary control.

#### IV. INTERVENTION IN MARKETS

So far the arguments of the *Campbell Report* in favour of free markets have been tested and found robust. They are fully consistent with the normal approach of economic analysis, and the findings which result from the examination of evidence. Before moving from examining the basic position of the report to consideration of certain details, one further issue must be examined. The government and monetary authorities have been enjoined to cease intervening in markets, to cease setting or stabilising prices. From the UK that is a persuasive position on one view alone; the tactics of the Bank of England in trying to set the price at which it sells government securities have led to tremendous swings in money growth and the exchange rate, and sometimes even in the rate of inflation. But nonetheless arguments for intervention must also be examined. These arguments are basically of three types - rates can be thought to be 'wrong', in that either they do not reflect all available information and hence would produce resource misallocation, or in that they are not at some socially preferred level; or sometimes governments intervene because some price series is thought to be too volatile. Can some sort of 'management' of financial markets be defended on any of these grounds? On the first point the answer is clear - and negative.

The markets in financial assets are efficient; there is no significant amount of wasted information and much of the ob-

<sup>11</sup> Such a system is known as control of the money supply by use of the monetary base. For detailed discussion of this system see Griffiths, B., *op cit.*, and Meltzer, A.H., 'Central Bank Policy: Some First Principles', *Annual Monetary Review*, No. 2., 1980, Centre for Banking and International Finance, The City University, London.

served 'noise' in prices is the result of the arrival of 'news' (to use a term introduced by Jacob Frenkel) - that is, of information which leads to a reappraisal of asset values.<sup>12</sup> This finding is consistent with earlier studies, and, in conjunction with work such as that by Levich,<sup>13</sup> clearly demonstrates that no case for official interest rate policy can rest on a claim that the asset markets, by failing to use all available information, produce prices which might cause resource misallocation.

Is it possible that one rate be in some sense socially preferred to another? If it is, it must be not because the rate is an end in itself, but because of its effect on resource allocation. As noted earlier in the context of the entry of foreign banks to the banking system, if it is desired to assist one sector of the economy, the best way to do it is by direct subsidy.<sup>14</sup> Second, even if the course of providing assistance by affecting interest rates is chosen, the only rates effective in allocating resources are real interest rates, market rates adjusted for expectations of future inflation, and those are quite outside the control of the monetary authorities. This argument for an interest rate policy is clearly defective.

What of rate volatility? Can that justify intervention? Again the answer is no. Since volatility, as noted above, reflects the arrival of new information, it is a perfectly rational aspect of the system's behaviour. Suppressing that volatility will not make it vanish, but will shift it elsewhere - to money growth most likely. It is not sensible to shift volatility from financial markets, which are accustomed to dealing with it, to markets in goods and services, not accustomed to such fluctuations and often inhibited by long-term contracts from dealing with them. Further, there is evidence that intervention in financial markets, by making expectations more volatile, **increases** rate volatility.<sup>15</sup>

<sup>12</sup> J.A. Frenkel uses this term most prominently in 'Flexible Exchange Rates, Prices and the Role of "News": Lessons from the 1970s', in *Exchange Rate Policy: U.K. Options for the 1980s*, edited by R.A. Batchelor and G.E. Wood, Macmillan, London, 1981.

<sup>13</sup> Levich, R.M., *Overshooting in the Foreign Exchange Market*, Occasional Paper No 5, Group of Thirty, New York, 1981.

<sup>14</sup> See Bhagwati and Ramaswami, and Wood (1975), both *op. cit.*

<sup>15</sup> This is shown in Batchelor, R.A., and Wood, G.E., 'Floating Exchange Rates: The Lesson of Experience', in Batchelor and Wood (eds.) (1981) *op. cit.* See also Griffiths, 1979, *op. cit.*

It must therefore be concluded that the views of the Campbell Report on the desirability of competition are correct. Free competition, and the absence of regulation inhibiting it, are as desirable in the financial markets as in any other.

Having reached that conclusion, and thus supported the main element of the Report, it is useful before concluding to mention some details which are of interest but have not emerged in the general discussion so far.

## V. SOME DETAILS OF THE RECOMMENDATIONS

So far it has been argued that the Campbell Report's general endorsement of competition in all aspects of the financial system is, although not supported by extensive argument in the Report itself, in fact well founded.

In the course of reaching that conclusion, certain of the Report's detailed recommendations were noted, but the bulk of discussion so far has dealt with general principles. In this section of the paper, therefore, it is useful to look at some of the detailed recommendations, as well as occasionally noting what has not been done.

Some considerable attention is paid to devising 'prudential' controls to regulate financial institutions. This is of course totally inconsistent with the Report's general endorsement of the free market - an endorsement which can only follow from the belief that consumers and producers know their own business better than anyone else. It might be argued in reply to that that the financial system is so important to the working of the economy that additional safeguards are necessary, but that, too, does not hold water. First, as indeed the Report notes elsewhere, it is the stability of the system *not* of individual institutions that is important, and the former can be safeguarded by an adequate lender of last resort facility. Second, consider what it means to have to satisfy compulsory prudential requirements. If the requirements are compulsory, they cannot be violated so if, for example there are compulsory reserve requirements or balance sheet ratios, firms will always have to hold, in addition to these legal requirements, whatever they would want to hold from their own prudence. This would go a long way to offset the efficiency gains which a more competitive financial system would produce.



### **Inconsistencies**

This recommendation is, indeed, directly at variance with those the Report makes with regard to the stock exchange - where competition over fees is encouraged, incorporation permitted, and foreign firms allowed to enter. All of these changes will surely be of benefit to investors by allowing them a wider choice of services. Making the futures markets subject to the same set of rules as the stock market is also sensible, as it recognises that both are essentially markets in long-lived assets, and not really different in economic characteristics.

There is also inconsistency in the Report's attitude to bank ownership. Shares in a bank are to be allowed to be more concentrated in ownership than they are currently. This is sensible. If the banking system is competitive, then competitive pressures are a sound check against anti-social behaviour by an individual. Yet entry of foreign banks is, as noted above, to be restricted. In some cases, then, the Report, while consistently espousing sensible principles, shies away from recommending their implementation in particular cases without explaining why they are doing so.

Such criticisms by and large do not apply to the extensive section of the Report which deals with consumer protection. The implications of the authors' understanding of the role of markets is there carried through with consistency and thoroughness to the detailed recommendations they make. A good example of this can be found in Chapter 18, the introductory chapter to this section, where the authors point out (paras. 18.22-18.29) that constraints by the authorities on licensing new entrants to an industry should take no account of any views the authorities may have on the optimal size of that industry. First, the view of the authorities may be wrong; and second, even if correct, the new entrant may be more efficient than an existing firm. There is also a welcome insistence on requirements to disclose information in a clear and readily accessible way, and forcefully expressed criticism of interest rate ceilings. Indeed, of this section of the Report only two criticisms should be made (apart from the earlier comments on the Report's advocacy of prudential regulation). The first is the recommendation that regulation be 'flexible'.

... prudential requirements laid down and supervised by the authorities in a flexible manner are preferable to the formal specification of requirements in legislation. (para 18.31)

That is just wrong. Another term for flexibility in this context is uncertainty. Such flexible regulation gives rise to suspicions of unequal or unfair treatment, and does not make clear to firms the kind of environment in which they are supposed to operate. That recommendation would just add unnecessary uncertainty to the world and should be rejected.

The second criticism is that the Report's case against selective credit controls could have been much stronger. They argue, correctly, that they impair the efficiency of financial intermediation. They would also have argued that by distorting market prices they complicate the conduct of monetary policy, and that they also have little effect on resource allocation.<sup>16</sup>

Such changes as the abolition of interest rate ceilings may, of course adversely affect certain groups in society, even though society overall gains. The authors of the Report face this issue and argue, clearly and correctly, that the best way to assist a particular individual or group is not to distort prices - that would lead to economy wide resource misallocation - but simply to give them funds.<sup>17</sup> In addition to the analytical reasons for that recommendation, a further point in its favour is that it makes explicit and visible to all the cost of the subsidy - which of course is why the subsidised groups often resist such proposals.

## VI. CONCLUSION

The Report's authors maintain that their conclusions and recommendations 'need to be seen as an integrated package'. This is correct in one sense, but misleading in another. Based as they are on an understanding of the working of markets, the recommendations are underpinned by a consistent, well thought out, and correct body of analysis. In that sense they clearly are an integrated package. But that does not mean that the Government must implement all or implement none. It *should* do so - for if it

<sup>16</sup> The first point is shown in Hamburger, M.J., and Wood, G.E., 'Interest Rates and Monetary Policy in Regulated Open Economies', Centre for Banking and International Finance, The City University, London, Working Paper No.10. The second can be found in Hamburger, M.J., 'The Demand for Durables and Credit Controls, Federal Reserve Bank of New York, 1979, Working Paper.

<sup>17</sup> The above noted papers by Bhagwati and Ramaswami (1963) and Wood (1975), are examples of the application of this principle to particular questions.

## A New Financial Revolution?

implements one, thereby accepting the underlying argument, it should implement all since the same argument underpinned all. But it does not have to behave in that way. It can, if it chooses, move one step at a time.

How should the government move towards deregulation? Some press comment immediately after the publication of the *Report* criticised the *Report's* authors for not dealing with that question.

. . . an unstated term of reference which the Committee has neglected is that the Government hoped that the Committee would tell it how to move towards deregulation in a politically acceptable manner. This the Committee has not done. It has effectively dodged the hard part - the transitional measures needed to convince the public and the electorate.<sup>18</sup>

This is not a well judged criticism. Perhaps the question has not been addressed explicitly - but the implicit answer is clear. The Government should go ahead with the recommendations as fast as possible; the best path is the quickest. Persuasion of affected interest groups will certainly be necessary - but that is a political matter, quite separate from any economic advice on how to reach the desired goal of a competitive financial system.

Overall the *Report* of the Campbell Committee must be welcomed. Its various recommendations are based on well-thought out, and correct, arguments. Criticisms of it can only be made, indeed, when the *Report* deviates from its own underlying principles.

If adopted, the recommendations of the *Report* will give Australia a more competitive and efficient financial system. That would be a substantial contribution to Australia's prosperity.

---

<sup>18</sup> *The Australian Financial Review*, Editorial, November 18, 1981.

# 5

## THE FISCAL ASPECTS OF THE CAMPBELL REPORT

A. R. Prest  
*London School of Economics*

**A.R. Prest** is Professor of Economics (with special reference to the public sector) at the London School of Economics. He is a graduate of Cambridge University. He held a Rockefeller Fellowship in the USA in 1948-49 and then taught at Cambridge where he was a Fellow and Bursar of Christ's College, and University Lecturer in Economics. In 1964 he was appointed Professor of Economics and Public Finance and in 1968 Stanley Jevons Professor of Political Economy at the University of Manchester. He took up his present position in 1970. Professor Prest is the author of many books including *Public Finance in Theory and Practice*; *Public Finance in Underdeveloped Countries*; *Transport Economics in Developing Countries*; and *The Taxation of Urban Land*. He is the editor of *The UK Economy and Public Sector Economics* and co-author of *Self-Assessment for Income Tax*. He has published papers in a variety of learned journals.

## THE FISCAL ASPECTS OF THE CAMPBELL REPORT

A. R. Prest

### I. INTRODUCTION

My brief is to write about some of the fiscal aspects of the *Final Report* of the Australian Financial System Inquiry. I shall construe this assignment to mean that I should cover both positive taxes and negative taxes (e.g. subsidies) affecting the financial system. Furthermore, I shall have occasion to refer to some public inpayments and outpayments which are implicit rather than explicit. Throughout I shall have in mind the principal concern of the Committee in this area i.e. 'the uneven impact of some forms of taxation on the pattern of funds flows'. (*Report*, p. xxvii)

Before proceeding further it is necessary to make some important disclaimers. First, I do not pretend to be a specialist on the working of financial markets anywhere, let alone those in Australia. Second, writing in London immediately after the *Report* was published means that I have not had access to the spate of comment which has no doubt erupted in Australia. Nor has it been possible to see or consult the *Commissioned Studies and Selected Papers* in the time available. In fact, the time constraint and the pressure of other duties have been such as to make it impossible to study the whole of the *Report* with the closeness it so obviously deserves. So what follows must be regarded as a set of initial reactions, and ones which might easily be modified later, from someone who is far away from the battle arena and is no expert on the details of the Australian economy.

I shall first of all list the main fiscal proposals made by the Committee. Then I shall say something about their general characteristics as I see them. Subsequently, I shall study one of the proposals, that for full integration of company and personal income tax, in some detail. Then I shall comment very briefly on some of the other proposals. I shall finish with a few concluding reflections.

One or two preliminary general observations about the content and style of the *Report* may be in order at this stage. The first is that the *Report* ranges very widely, attention being given to a large variety of subjects. No reader, however specialised his own interests might be, can fail to be impressed by the attempt to cover subject matter

normally divided up between a whole series of committees of experts. In the UK, for instance, there have been three separate major Committee reports in the last decade or two dealing with consumer credit, small firms, and financial institutions generally. The Campbell Committee covers not only these three topics but also, as we have seen, has a number of things to say about fiscal matters too. Nor is it just that the breadth of coverage is so impressive. It is also clear that the Committee did not shirk its duties and did take the trouble to commission expert studies, make foreign visits and so on. In fact, the nearest parallel I can think of as a rival achievement is the famous Royal Commission on Taxation in Canada (the Carter Commission) in the 1960s.<sup>1</sup> Not only is there a resemblance in covering a large subject in great detail and with great seriousness but the intellectual approach is in many ways very similar. The Campbell Committee takes the line that the essential question to ask about government intervention whether by fiscal, monetary or regulatory action is how the neutrality, equity and simplicity of the financial system is affected. So there are three basic criteria; but, to echo biblical language, the greatest of these is neutrality. In just the same way as the Carter Commission took an uncompromising line in nailing its colours to the mast of the pure comprehensive income tax, so the Campbell Committee sees a world of black and white only. Something is neutral or it is not; and if the latter judgement is passed the sentence is eternal damnation. The colour grey does not exist in its vocabulary, its attitudes, or its judgements.

So the parallels to the Carter Commission are close in more ways than one. We shall have something to say later about the fate of that earlier report and speculate whether further parallels are likely to be found in that respect too.

Before coming to more detailed argument there is one further general matter. No one could complain that the Report is not clear. The short paragraph and sharp staccato sentence approach see to that. But all the same I, for one, would like to register a protest about the murder of the language of Shakespeare and Milton in a multitude of ways, not least the continuous use of nouns such as 'impact' as transitive verbs. No doubt such a protest will be written off by many as being that of an old-fashioned fuddy-duddy. If so, I am happy to put on that cap in this cause.

---

<sup>1</sup> *Report of Royal Commission on Taxation*, Queen's Printer, Ottawa, 1966.

## **II. FISCAL PROPOSALS**

One point to make at the outset about the coverage of the Report is that it is essentially concerned with financial rather than real resource flows. It is not primarily concerned with the allocation of real resources between different competing ends - housing versus manufacturing industry, for instance - as distinct from analysing any features of financial markets which have a differential impact on such allocations. So if the tax system is such as to impinge on financial flows in some non-neutral way the Committee is very much interested; but if the fiscal system achieves the same allocation of real resources by, say, direct relief on plant and machinery purchases, that element of non-neutrality is of no direct concern to the Committee even though the consequences are just as, if not more, important. This is an important point which both needs emphasis at the beginning and re-emphasis at later stages.

The main fiscal proposals of the Committee are as follows:

### **1. Company Taxation**

- (a) the full integration of company and personal income taxation by the device of removing the veil from corporations and in effect treating such entities as if they were partnerships.
- (b) Division 7 tax. The whole issue of over-retention of profits by private companies, thereby jeopardising the government's revenue intake, is examined closely. Full integration as in (a) would solve the problem; alternatively, the existing regulations can be maintained, though firms might also be given the choice of being treated either as a private company or as a partnership.
- (c) Groups of companies with 100% common ownership should be treated as a single entity for tax purposes so that losses by one member of the group can be offset immediately against profits of another.

### **2. Taxation of financial intermediaries**

Various detailed proposals for rationalising the fiscal treatment of life assurance companies, superannuation funds, building societies and credit unions were put forward.



### **3. Taxation of specific transactions**

Stamp duties were regarded as a source of non-neutrality and so should be scrapped if possible. The withholding tax on interest paid abroad should be cleaned up, and a better definition of capital gains of different kinds which should be regarded as trading income (and hence taxation as ordinary income) was sought.

### **4. Inflation and indexation**

This subject crops up at various points in the report - the issue of index-linked bonds by government (Chapter 11), the principles of constructing an indexed system of company and personal income taxation (Chapter 17) and the more general issues of inflation and the financial system (Chapter 43).

### **5. Implicit taxes**

The arrangements whereby life assurance and superannuation funds have to hold prescribed proportions of their assets in government bonds, thereby suffering the equivalent of differential taxation, were examined and found wanting.

### **6. Subsidies**

The Report has quite a lot to say on implicit subsidies (e.g. interest costs of mortgages) and on explicit subsidies (e.g. to small business firms).

## **III. TAX INTEGRATION**

We shall now examine in some detail the major fiscal reform suggested by the Committee i.e. the replacement of the current Australian system of taxing companies and shareholders separately by one in which shareholders are deemed to receive a share in retained company profits as well as cash dividends when it comes to assessment of personal income tax liability. If this device is adopted the taxation of companies as such can be abolished and shareholders are instead taxed on the total of their actual and imputed incomes. The only tax role then played by companies is that of withholding some or all of the personal income tax payable by their shareholders.

This idea is not new. It was examined at length and endorsed by the Carter Commission in 1966. For that matter I can claim to have seen the light myself as far back as

1960.<sup>2</sup> It has also been discussed at length in some well-known US publications in recent years.<sup>3</sup> Nevertheless, most authorities exploring this subject have been cautious about endorsing full integration across the board, and have been inclined to limit it to, say, private companies initially. But the Campbell Committee endorses the idea unreservedly. So we must list and probe its arguments in some detail. We shall begin with those relating to general economic efficiency, and then look successively at equity considerations, administrative matters, international repercussions, and finally, a number of miscellaneous points.

The Committee argues for the efficiency advantages of full integration on several familiar grounds. A system of taxing companies and individuals separately is likely to lead to over-retention of profits, to over-reliance on debt finance and to the favouring of the non-corporate sector generally. So for all three reasons distortions are introduced; and these could all be avoided by full integration. One or two other efficiency arguments are also mentioned but the above are the principal ones.

The first observation is that the Committee pays very little attention to the possibility of company taxes being shifted forward on to purchasers rather than being borne by shareholders - in fact astonishingly little, given the vast amount written on this subject. However, in this particular context that element of neglect is not critical. For example, corporate enterprise is discouraged relative to unincorporated enterprise whether the separate tax system leads to rises in the prices of goods and services produced by companies or to reductions in the net rate of return obtainable by their shareholders; and those companies with high equity/debt ratios will be at a disadvantage compared to those with low ratios whichever way the separate company tax seeps through the system.

There are, however, a number of efficiency drawbacks to full integration as proposed by the Committee. First of all, it has to be remembered that this Committee's proposals are unlike those of the Carter Commission in one important respect: they are advocated in the context of the generality of

<sup>2</sup> Prest, A.R., *Public Finance in Theory & Practice*, First Edition, Weidenfeld & Nicholson, London, 1960 p. 330.

<sup>3</sup> For example, US Treasury, *Blueprints for Basic Tax Reform*, Government Printing Office, Washington DC 1977; and McClure Jr, C.E., (editor), *Must Corporate Income Be Taxed Twice?*, Brookings Institution, Washington DC 1979.

## A New Financial Revolution?

capital gains not being subject to tax. But insofar as profit retentions correspond to some elements of capital gains - this point being recognised by the Committee's proposal (p. 214 fn. 11) that shareholders be allowed to add retained earnings per share to acquisition cost in the event of any general capital gains tax on realisations being introduced - the system of full integration does amount to a tax on some capital gains but not on all. So we have a situation where some types of inefficiency will be diminished by full integration but some others potentially worsened. It may be that the latter category is very small beer but the Committee make no overt reference to the subject, let alone attempt to quantify it.

Another problem is the treatment of losses. The Committee (p. 230) is opposed to the allocation of losses to individuals on the well-known grounds that trafficking in such losses might open up substantial tax loopholes. But consider the efficiency consequences of *not* allocating losses. Company A makes profits of 100 in each of two successive years; company B makes a profit of 300 in year 1 followed by a loss of 100 in year 2. Non-allocation of losses to shareholders will mean that the tax base for years 1 and 2 combined will be 200 in the A case but 300 in the B case, when it should clearly be the same in both. Nor is this all. Essentially the same problem can arise if dividend payments exceed profits in any year but there is no system of allocating negative as well as positive retentions to shareholders. It may be that the research studies commissioned by the Committee pay attention to the resultant inefficiencies of such a system but there is no overt sign that the Committee itself recognised the problem, let alone that it had any solution for it.

Other efficiency questions can easily be found in the literature. One is whether managerial attitudes to corporate policy are likely to be different when tax liabilities are placed on shareholders rather than companies. Another is that if the system of full integration reduces the tax yield below that obtaining under a separate system, it is necessary to ask how one compensates for the revenue shortfall and what will be the efficiency consequences of the relevant tax change. It might be noticed on this point that the Committee (p. 218 fn. 12) thought that the net tax cost of full integration would be no more than 1-2% of current total income tax revenue; an estimate for Canada put the cost of full integration at 33% of personal income tax revenues in 1977.<sup>5</sup> There would seem to be a major discrepancy here.

<sup>5</sup> Bird, R.M., *Taxing Corporations*, Institute for Research on Public Policy, Montreal, 1980 p. 28.

There are standard equity arguments for moving to full integration and the Committee makes them clearly enough. For any given level of investment income the tax burden under the separate system differs between corporate and non-corporate enterprise; and the excess tax burden is disproportionately high at lower income levels. The Committee also correctly notes that full integration would necessitate basis amendment in the event of any general capital gains being introduced though it does not make clear whether there should be corresponding amendments for negative profit retentions or any element of indexation in these adjustments.

It is not suggested that full integration could be implemented immediately and the Committee envisages a phasing-in period. During that time companies would continue to be taxed at (the current rate of) 46% of profits but this would now be a withholding tax on shareholders' income (cash dividends plus imputed retentions) and not a company income tax as such. Shareholders liable to tax at a rate in excess of 46% would pay additional tax but those paying tax at a lower rate would not receive any refund on the grounds that they would benefit anyway from the conversion of the two taxes into one. Subsequently, the withholding rate could be reduced from 46% to 32% though it is not clear how this would operate in detail nor whether it is envisaged that the withholding rate would ultimately fall still further.

One can see the reasoning behind this approach. Choice of a withholding rate must take account of such factors as the need to keep down the number of cases where further tax payments will be needed and must also be chosen with an eye on the treatment of inward investment. And it is perfectly reasonable to argue that the benefits of integration to lower income groups should be phased in slowly. At the same time, there are some awkward matters which the Committee does not face properly. One is the treatment of zero-rate personal taxpayers such as charities who (unlike low positive rate taxpayers) do not benefit at all during the 46% rate interim withholding period. The somewhat complaisant attitude adopted by the Committee to this anomaly (pp. 231-32) is unlikely to commend itself to the bodies affected thereby. Nor is any explanation given of why the withholding rate should be reduced later from 46% to 32% rather than, say, keeping the 46% rate but gradually introducing a system of credits to lower-rate taxpayers.

The proposition that any company tax burden on shareholders would have been capitalised in share prices long ago and that those who then lost in the process are unlikely to

### *A New Financial Revolution?*

be the same people as those who gain today from integration is acknowledged but not developed by the Committee. I would have thought that this is a much more important equity point than the Committee allows, given the absence of any comprehensive system of taxing capital gains.

We must also return to the subject of forward shifting. If the company tax has been shifted forward in the past but the switch to integration does not result in 'unshifting' we then not only have capital gains for current as opposed to earlier shareholders but also capital gains which do not correspond to capital losses at any previous stage. The Committee shows no signs whatever that it appreciates such subtleties.

Another topic absent from the Committee's discussion is that of cash-flow. It has long been recognised that full integration may involve higher tax payments than cash dividends whether through rich shareholders investing in companies with low payout ratios or through prior claims of preference over equity shareholders.<sup>5</sup> It must be recognised that, however logical, economists have never been very successful in persuading laymen that tax payments in excess of cash-flows are appropriate. It does the Committee's case no good at all to be completely silent on this subject.

Finally, it should be noted that if formulated with care, proposals for integrating the taxation of dividends, whether of the split-rate or imputation form, can go quite a long way in ironing out horizontal inequity (and for that matter resource misdirection) even though they are not as effective on the vertical equity side as full integration. But the reader who is not an expert in these matters would certainly not get that impression from the Committee's discussion on pp. 215-16.

On administration the Committee does make an attempt to sketch in the major issues and the possible solutions. One question is the day of record, i.e. how does one allocate profits to a shareholder who has held his shares for less than a full year; others relate to the re-opening of company and individual tax accounts as a result of audit or tax appeals and others to the appropriate treatment of inter-company dividends under a system of full integration. The Committee goes as far as could reasonably be expected on such matters in this Report though I would strongly suspect that an inquiry in depth by experts in tax administration would be needed before the suggested reforms could be put into practice.

---

<sup>5</sup> See e.g. Prest, A.R., *loc. cit.*, and Shoup, C.S., *Public Finance*, Aldine, Chicago, 1969 p. 319.

One would need, for instance, to look at phasing-in very closely. It can reasonably be argued that it might make sense to start with full integration for private companies; on the other hand, the cash-flow difficulties mentioned earlier might well be more pressing in such cases, given the lesser marketability of private company shares compared to public ones.

One of the the major hesitations which most people have about recommending full integration relates to the treatment of inward and outward investment in a country. It cannot be said that the single page of discussion in the *Report* (p. 232) allays such doubts.

First of all, the Committee confines itself to matters of inward investment. It does not face up to more general issues such as what the world would be like if all countries adopted full-integration. The pure logic of the approach would imply that taxes would be all levied in the country of shareholder residence and none at all in that of profit origin. For the world as a whole that would produce a situation of capital export neutrality but also substantial shifts in tax revenue to net investor countries. One need only mention such an outcome to visualise the screams of protest which would be made at every international forum on the face of the earth. One can understand the Committee's desire not to stir up that particular hornet's nest but its omission of any reference whatever to outward investment from Australia and how the system of full integration is supposed to apply in that case is far less excusable. How, for instance, is the imputation of retained earnings by Du Pont or ICI supposed to be made to an Australian portfolio investor in such corporations? And it might be noted that McClure, after considering how the US system of foreign tax credits might be attributed to individual shareholders rather than corporate enterprises came to the conclusion<sup>8</sup> 'it does not seem to be a viable alternative'.

On the subject which is considered by the Committee, i.e. inward investment, the general line taken is that in effect the existing system of 46% corporate tax plus a withholding tax of either 30% or 15% on dividends paid abroad should be maintained. Logic would require no Australian tax on such investment income; but the price of such logic would be a substantial loss of revenue to the Australian Treasury - and we all know what line governments take in these circumstances. Nevertheless, one does get the feeling that the Committee is trying to have its cake and eat it. *A priori*, it

---

<sup>8</sup> McClure, *op. cit* p. 159.

## *A New Financial Revolution?*

would be much more reasonable to apply the same withholding rule (initially 46%) at corporate level to all shareholders domestic and foreign, and then not to impose any additional dividend withholding tax on foreign shareholders. And in practice the Committee is simply deluding itself if it seriously thinks it could get away with such (sharp) practices as those proposed. To see this, one need only look at the way the UK has had to extend credits to shareholders resident abroad and more recently in respect of certain foreign companies since it introduced the imputation system in 1973. In short, this part of the Report needs to be taken back to the drawing board.

In this final section on company tax integration we must mention some of the omissions from the Committee's arguments and try to put them in historical perspective.

One approach is to look at the various issues raised by McClure which are conveniently summarised under eight headings in his book<sup>7</sup> as follows:

- \* Basis adjustment for capital gains tax
- \* Apportionment of corporate income among different classes of stockholder
- \* Day of record problems
- \* Retrospective adjustments
- \* Chains of firms
- \* Treatment of tax preferences to companies
- \* Inward and outward investment
- \* Cash-flow problems

From our preceding discussion, it can be seen that the Committee either omits some of these topics or does not discuss them adequately.

It must also be recorded that the Committee did not make any detailed estimates of the consequences of substituting an integrated system for a separate one. There are well-known examples of such exercises<sup>8</sup> and one might at least have expected some attempt at quantification on these

<sup>7</sup> *Op. cit.*, pp. 216-7.

<sup>8</sup> See, for instance, Feldstein, M.S., and Frisch, D., 'Corporate Tax Integration: The Estimated Effects on Capital Accumulation & Tax Distribution of Two Integration Proposals', *National Tax Journal*, March 1977; another very recent example is Fullerton, D., King, A.T., Shoven, J.B., and Whalley, J., 'Corporate Tax Integration in the United States: A General Equilibrium Approach' *American Economic Review*, September 1981.

or alternative lines.

We referred earlier to the lack of justice done to imputation and split-rate systems. Another alternative, nowhere discussed, is the flow of funds approach endorsed by the Meade Committee.<sup>9</sup> Nor does the neutrality claim for this approach in preference to the usual corporation tax arrangement (including interest deductibility and accelerated depreciation provisions) get any wind at all.

One might also wish that the Committee had been a little more mindful of history in these matters. The Carter Commission's proposals for integration fell flat on their face in Canada. And although the Committee does refer on numerous occasions to the Asprey Committee reports in Australia,<sup>10</sup> it does not explain why it felt able to put the argument for integration so strongly when the judgement of the earlier Committee was so decisively against it.<sup>11</sup> And unless the Australian Treasury has performed a remarkable *volte-face* since that time their attitude is also quite clearly hostile to such a proposal.<sup>12</sup>

To date, no country has implemented a completely integrated tax system partly, it is understood, because of administrative complexities and partly because of difficulties in the international tax area.

#### IV. OTHER PROPOSALS

After the discussion in depth of one of the Committee's main fiscal proposals we can be content with some very brief observations on some of the others.

##### 1. Life assurance superannuation funds

The regulations affecting investment of funds (the '30/20 rule') are discussed in Chapter 10 and the details of current and proposed taxation arrangements in Chapter 15. Both chapters are clear in description and in recommendations. But there is no attempt to analyse the 30/20 rule for what it is - a form of compulsory lending to government which is an implicit form of taxation. This is a subject which has been

<sup>9</sup> Meade, J.E., et al., *The Structure & Reform of Direct Taxation*, Allen & Unwin, London, 1978, Chapter 12.

<sup>10</sup> *Preliminary Report (1974) and Full Report (1975) of Taxation Review Committee*, AGPS, Canberra.

<sup>11</sup> *Full Report*, p. 228.

<sup>12</sup> *Treasury Taxation Paper No 9., 1974*, p. 13.



## *A New Financial Revolution?*

analysed from time to time in the literature and the Committee's exposition would have been improved if it had expressly looked at these regulations in that way.

### **2. Housing finance**

The distortions in the housing finance market are made very clear in Chapter 37 but there is no more than an isolated reference to the non-taxability of imputed income from owner-occupied housing. The Committee might well argue that its concern was with housing finance rather than housing as such; but insofar as any attention has to be paid to the latter topic, it might be that non-taxability of imputed income is more important than cheap finance as a stimulus to house purchase. I do not pretend to know whether this is so or not but would feel happier if the Committee had devoted a little attention to the subject - and for that matter to quashing the idea that non-deductibility of mortgage interest is a perfect substitute for taxing imputed income. More generally one has to think about implicit subsidies as well as the implicit taxes arising under 1.

### **3. Stamp duties**

One can applaud the Committee's condemnation of these current fiscal practices and the exposure of their consequences in Chapter 16. But it is worth remembering that Ricardo observed in his *Principles* in 1817 that such taxes 'prevent the national capital from being distributed in the way most beneficial to the community' and that J.A. Hobson<sup>13</sup> condemned them in the UK in 1919 in that 'for the most part they are the cumbersome relics of a past haphazard method of catchpenny improvisation which has no place in any scientific system of finance'. But such duties are very much alive and kicking in the UK to-day - without even the backing of being a source of finance to State governments, as in Australia.

### **4. Inflation adjustments**

The chapters dealing with index-linked bonds, the inflation-proofing of the tax system and the financial system under inflationary conditions (Chapters 11, 17 and 43 respectively) are clear and well-argued and I have no comments on the

---

<sup>13</sup> Hobson, J.A., *Taxation in the New State*, Methuen, London, 1919, p. 125.

exposition of the principles at issue except to observe that for completeness - and it makes no sense if one does not have completeness - one has to think about inflation-adjustment to indirect taxes as well as those described.

### **5. Small business**

The favoured form (p. 700) of special assistance is to make subscriptions to shares in small business investment companies deductible against personal income tax. This is presumably an analogous idea to that of the Business Start-up scheme introduced in the UK in 1981 (though, no doubt, too late for the Committee to refer to). Analytically, such schemes lie very uneasily within the ambit of a personal income tax as distinct from a personal expenditure tax structure. And all sorts of nasty questions arise such as the tax treatment of the funds withdrawn from such enterprises. One cannot help feeling that the Committee did not think through all the ramifications of that particular idea. Those who think otherwise should read the relevant section of the UK 1981 *Finance Act*.

### **V. CONCLUSION**

In conclusion, one can certainly admire many features of the *Report*. It is written with a unity of purpose, indeed almost a sense of mission, and it drives through with gusto to firm and clear-cut recommendations over a wide range of economic activity. Moreover, when one looks at the fine print it becomes clear that the Committee's bark is worse than its bite and some of its proposals are hedged about so that they are not quite as uncompromising or brash as they might appear at first sight. It will undoubtedly be remembered for a long time to come whenever these topics are discussed and even when they are not. It may be that the old Scottish warning 'The Campbells are coming' will acquire a new meaning for those who have been cocooned for too long in various activities sheltered by myriad government regulations and controls.

But looking at the fiscal proposals in particular one can also see various drawbacks. There is sometimes a tendency to mistake shadow for substance and spend unnecessary time on less important issues. Some proposals are not argued in sufficient depth and some objections to the Committee's ideas are swept aside without adequate consideration. The Committee certainly does not pay sufficient attention to the reasons advanced on previous occasions against some of its

### *A New Financial Revolution?*

pet ideas. It is also inclined to forget the old adage that the best is the enemy of the good in its anxiety to persuade readers of the rightness of its cause. In short, single-mindedness degenerates into simple-mindedness on some occasions.

But it would be totally unfair to the immense labours of the Committee members if I were to conclude my remarks without re-emphasising that they really are the product of a rush job. A final judgement requires much more extended study than has been possible in the time available. And what better tribute could any Committee want than that?

# 6

## COMPETITIVE NEUTRALITY

The Key Concept in the Campbell Report

Tim Congdon  
*L. Messel & Company*

Tim Congdon is Economics Partner with London stockbrokers L. Messel & Co. He was educated at St John's College and then at Nuffield College, Oxford. From 1973-76 he was economics correspondent on *The Times* before joining L. Messel & Co. as Senior Economist in 1976. He is the author of *Basic Economics, A Dictionary of Terms, Concepts and Ideas*; *Monetarism, An Essay in Definition*; *Against Import Controls*; and *Monetary Control in Britain*. He is a frequent contributor to the financial press and is economics writer for *The Spectator*.

## COMPETITIVE NEUTRALITY

The Key Concept in the Campbell Report

Tim Congdon

### I. INTRODUCTION

Major public policy debates are often resolved by a search for consensus. Governments, unable to decide the merits of contrasting positions, attempt to establish a middle ground in the hope that the outcome, if not ideal, is at least more or less tolerable for all. This almost inevitable characteristic of political decision-taking suggests the debating strategy of presenting a well-defined, coherent and apparently extreme case in order to shift the middle ground in a desired direction. The achievement of the *Campbell Report* is to have done precisely this. By arguing for a thorough liberalisation of the Australian financial system, without any compromise of its free market stance, it has changed the intellectual environment in which future discussion will take place. A more cautious and diffident report could not have had the same impact. The many special interests which benefit from the existing regulatory framework are now obliged to use the vocabulary and to counter the proposals of economic liberals. They are necessarily on the defensive.

Perhaps the most persuasive idea advanced by the Campbell Committee is competitive neutrality. Introduced early in the *Report*, it is categorised as one objective of government intervention. The crux of the idea is that government actions, by maintaining 'consistency in the regulatory and taxation burdens imposed on different intermediaries, should have 'a fairly neutral impact on fund flows'. This is very difficult to oppose. There is a strong appeal to those not directly involved in the debate because the emphasis on the uniform application of a regulatory system seems impartial, even-handed and logical. Competitive neutrality brings to mind other principles, such as equality before the law, which are an integral part of modern civic life.

Indeed, it is no exaggeration to say that competitive neutrality is the conceptual pivot of the *Campbell Report*. In the list of objectives of intervention, efficiency and diversity of choice are mentioned separately, but in truth both are subsidiary to it. If we take efficiency first and interpret it in the allocative sense, the reasoning is

straightforward. In a financial system where certain intermediaries are aided by government money or other privileges, resources are channelled towards those intermediaries at the expense of other intermediaries. Because the favoured intermediaries attract some fraction of the available resources not because of their true profitability, but purely because of the subsidies they receive, these resources are wastefully used and misallocated. Efficiency is clearly undermined.

The same line of argument is readily extended to demonstrate the potentially adverse effect of official discrimination on diversity of choice. As resources are directed to inefficient intermediaries by artificial government assistance to them, fewer resources are available to efficient intermediaries and their costs rise. In consequence, they may not compete in as many parts of the financial market as they otherwise would, leaving badly-run (and often government-owned) organisations free to exploit the consumer. The consumer's diversity of choice is reduced by the reluctance of well-managed companies to enter an area of business because they will not be allowed to compete on equal terms with established high-cost concerns.

The connection between competitive neutrality, efficiency and diversity of choice is basic to the *Campbell Report*. Much of the *Report* becomes meaningful only if the interdependence of the three concepts is understood and remembered. For example, the need for neutrality is noted repeatedly in the chapters on the taxation of financial intermediaries. Its relevance here hardly needs to be emphasised. But the three concepts are asked to do the most work - and are also at their most effective - in two particular sections, one on 'Government-Owned Financial Institutions' and the other on 'Sectoral Finance'. In the first part of my paper, I shall discuss and defend, if with some reservations, the *Report's* recommendations in these two sections.

But the *Report* is not perfect. Although one of its greatest strengths is the advocacy of equitable treatment for financial intermediaries, as required by competitive neutrality, it is not altogether consistent on this theme. At several points there seems to be a misunderstanding of the proper relationship between a central bank and private commercial banks. This misunderstanding gives rise to proposals, notably for a variable reserve ratio on banks, which would disturb equal competition between different types of intermediary. The second part of the paper is therefore devoted to an analysis of central banking functions which argues that balance sheet ratio controls of any kind on

private banks are undesirable and that monetary policy can be conducted successfully in the absence of such controls.

Finally, the problems of transition from the present arrangements, in which competitive neutrality is violated by many institutions in many ways, to a more liberal system need to be appraised. The Report frequently says that there will be problems; it rarely says what they will be. This is surprising as much can be learned from the experience of other countries, notably the USA and Britain, where major programs of financial liberalisation have been implemented in recent years.

## II. COMPETITIVE NEUTRALITY AND GOVERNMENT-SUPPORTED FINANCIAL INSTITUTIONS

Although the Campbell Report's recommendations on government-supported financial institutions are likely to arouse great hostility, they ought to be its least controversial. The protests are likely to be loud, not because they are well-founded, but because they come from specific institutions with employees and customers directly affected by the Report's proposals. Some of these employees and customers can and will make a noise. What are the Report's recommendations? And why should the government ignore the noise?

Over the years several government-supported financial intermediaries have developed in Australia. They fall into two categories. First, there are a miscellany of small institutions which either cater for special interests or are meant to further something deemed to be a 'good cause' like high technology or new, risky businesses. These include the Primary Industry Bank of Australia (PIBA), the Rural Credits Department of the Reserve Bank and the Australian Industry Development Corporation (AIDC). In all cases, their purpose, often stated quite explicitly in their charters, is to lend at least part of their resources to an identified interest-group (farmers, primary producers) on non-commercial criteria. The Report takes a consistent line on these institutions. They should be disposed of to private sector interests or wound up.

Secondly, there is the Commonwealth Banking Corporation, a large group which contains the Commonwealth Trading, Savings and Development Banks. The Commonwealth Trading and Savings Banks are managed as profit-making concerns; the Commonwealth Development Bank (CDB) is regarded, on the other hand, as being 'not primarily a commercial enterprise'. The Report favours the eventual



## A New Financial Revolution?

absorption of CDB into the Commonwealth Trading Bank in order to end its non-commercial activities. This is in harmony with the recommendations on small government-supported institutions. But, once the whole Commonwealth Banking Corporation is commercial, the Report does not want it to be sold off and denationalised. Instead a number of performance criteria are laid down to ensure parity of treatment, and hopefully equality of competition, between the Corporation and its privately-owned rivals.

The argument for the sale or winding-up of government-supported financial institutions rests on the unfair competition they provide against privately-owned institutions and the consequent misuse of society's scarce resources. It is quite clear that a loan or investment proposal turned down by a private bank may, in certain circumstances, be accepted by concerns such as the CDB or the PIBA. This leads to two kinds of inefficiency. There is, first of all, the management and administrative time spent on risk assessment in a non-commercial organisation which could have been better used in the profit-maximising environment of a private bank. This inefficiency is specific to the financial sector.

But there is also, and much more importantly, the damage to resource allocation outside the financial sector. When a loan is granted to a farm or a small business, the farm or small business obtains command over resources of labour and capital. These resources are devoted to the particular end the farm or small business has in mind. But they could have been employed elsewhere, in a mine, factory or a large retailing chain. Because the loan extended by the CDB, the Rural Credits Department of the Reserve Bank or the like, does not need to yield as high a return as a loan appraised by a private bank, the value of the farm's or small business's output is likely to be less than that of these alternative production units. The community as a whole is made poorer by the operations of the government-owned intermediaries, however benign they are in intention and despite the 'social objectives' for which they were created.

The defenders of government-supported financial institutions may say that farms, small businesses, primary producers, high-technology or whatever are good and should be encouraged. No one disagrees with that; no one thinks that they should cut their production or reduce their employment if it can be avoided. The trouble is that, when the quantity of resources a society has available for investment is fixed, to help one sector is simultaneously and necessarily to penalise others. The more loans are received by rural industries or small companies, the fewer loans can be

given to urban industries and large companies. To be 'for' the CDB, the AIDC and the PIBA is also to be 'against' the Australia and New Zealand Banking Group, the Bank of New South Wales and the Commercial Bank of Australia - and, more particularly, it is to be against the loans these banks could give to profitable, efficient and well-run companies.

Competitive neutrality, by repudiating the discriminatory lending powers of government-supported financial intermediaries, would help stop resource misallocation. Moreover, by emphasising the need for impartiality between institutions, it supersedes the 'for' and 'against' rhetoric. When people believe that government policies will be guided by the principle of competitive neutrality, the incentive for time-wasting political lobbying by particular interest groups or financial institutions is reduced.

The case for the sale or winding-up of small government-supported financial institutions is compelling. It must be hoped that the Australian authorities accept the Campbell Report's recommendations on this subject in their entirety. However, the Report is far more equivocal about the Commonwealth Banking Corporation. Although at one stage it judges that, once its recommendations have been implemented, there would 'cease to be justification on efficiency grounds for continued government ownership of banks', it does not come down in favour of private ownership for the Corporation. Some quasi-political objections, such as the competing jurisdictions of state and federal authorities in the banking field, are raised against denationalisation. It is difficult for a non-Australian to assess these objections, but they do not seem convincing. Paragraph 27.16, which refers in a sympathetic way to the legislation governing the Commonwealth Banking Corporation, is by far the worst in the Report. There must be a suspicion that the real reason for the Report's tame recommendations is that it does not wish to antagonise the Corporation, which accounts for nearly 30 per cent of all deposits in Australia, and invite the accusation of attempting the 'politically impossible'. To quote the craven language of paragraph 27.14, 'Public sentiment and opinion will bring further influence to bear, and the Committee is mindful of all these elements.'

### **III. COMPETITIVE NEUTRALITY AND THE IMPLEMENTATION OF MONETARY CONTROL**

However radical its proposals on government-supported financial institutions, the Campbell Report is reassuringly orthodox on monetary control. It considers that the

## *A New Financial Revolution?*

authorities should as at present, 'formulate, announce and seek to achieve a monetary target'. On the whole, it inclines towards a broad money measure, such as M3, as the appropriate target variable, although there are some friendly remarks about 'examining alternatives to M3' and monetary base control. Since M3 is dominated by bank deposits, the Report's recommendations imply that monetary control is more or less equivalent to regulating the growth of bank balance sheets. In Chapters 3 to 6, which deal with these questions, there is little mention of competitive neutrality. A reasonable deduction is that the Committee does not think there is much overlap between its views on monetary control and the need for a non-discriminatory stance by the Reserve Bank towards private financial institutions. In fact, there is an important area of overlap and the Committee is wrong to neglect it. Unfortunately, we need to discuss monetary control procedures in some depth before the connection with competitive neutrality becomes clear.

There is a characteristic textbook account of monetary control. Its starting point is the familiar observation that banks maintain a certain proportion of their assets in the form of cash (or near-cash) reserves. The ratio of these reserves to deposits is relatively stable, but can be varied by the central bank if it so wishes. As cash is a liability solely of the central bank, it can fix the amount held by the banks. This power, combined with the option to vary the reserve/deposits ratio, enables the authorities to determine the level of bank deposits and so the money supply. The reserve/deposits ratio therefore seems to provide an ideal handle for monetary control. The Campbell Committee agrees with this verdict and proposes that 'a variable reserve ratio on banks should be available to the authorities as an instrument of monetary control'. It is of the essence in this proposal that the reserve ratio, at whatever level it is set, be a mandatory minimum beneath which banks are now allowed to fall.

A form of reserve ratio does already exist. Banks must keep a certain proportion of their deposits in Statutory Reserve Deposits (SRDs) with the Reserve Bank. From time to time the SRD ratio is varied for monetary policy purposes. The banks have criticised the SRD ratio because no interest is paid on the money they leave with the Reserve Bank, an arrangement which reduces their profitability. (An estimate on p. 67 is that the ratio 'costs' the banks  $\$^{3/4}$  for every \$100 of deposits.) The Committee sympathises with the banks and urges that 'a near-market interest rate should be paid on required deposits with the Reserve Bank'. As long

as such interest is paid, it seems to have no serious doubts about the desirability of a mandatory reserve ratio or about the efficiency of variations in the ratio as an instrument of monetary control. The Committee also considers that 'the precise determination' of the interest rate on reserves is a subject on which it is 'not necessary to comment'.

The whole approach to the regulation of bank deposits (which may be termed the banking multiplier theory) suffers from an analytical flaw. It is taken for granted that deposits will be whatever multiple of banks' cash the authorities decide. This multiple is viewed as the determinand of administrative fiat, as a purely mechanistic relation between one quantity and another. There is no attempt to understand the behavioural influences on the reserve ratio; there is no awareness of the functional role performed by cash in bank operations. The Committee fails to ask two important questions 'why do banks hold cash reserves?' and 'what amount would they want to retain if they had the freedom to choose?' We must provide our own answers.

Banks keep reserves because a deposit is an obligation to repay cash when the due notice (if any) has expired. There are two ways in which depositors ask for repayment - by cash withdrawal over the counter and by writing out cheques. (A cheque is an instruction to move cash from a bank account to its recipient. In practice the recipient usually wants it credited to his bank account and it passes through the cheque clearing.) Both forms of claim on their cash have to be anticipated by banks which therefore have a continuous need for reserves. If their cash dropped too low, they might not have enough to meet their repayment obligations. However, cash pays no interest. So any excess of cash over the banks' business requirements involves them in a loss of profits because this part of their resources could otherwise have been invested in interest-bearing assets. The amount of cash a bank wants to hold is determined as a compromise between two influences - on the one hand, the need to satisfy obligations arising from deposit withdrawals and cheque clearing; and, on the other, the pressure to maximise profits. The desired cash reserve therefore reflects genuine business motivation, just as a price reflects supply and demand.

It follows that the reserve ratio should not be - and, indeed, cannot be - an instrument of monetary policy. Suppose that the authorities want to reduce the quantity of deposits and that they raise the reserve ratio above the level desired by the banks themselves. The banks may comply with the request, but they have an excess supply of

## *A New Financial Revolution?*

reserves. The typical response is to enter a different field of financial intermediation, such as consumer finance through a new subsidiary or offshore lending by an overseas branch, where the excess reserves can be put to some use. (Offshore lending on a large scale is, of course, only possible in the absence of exchange controls, which, in fact, the Campbell Report wants the Australian government to phase out.) These escape-route lending opportunities lead to the creation of financial assets, probably as liquid as the bank deposits that would otherwise have arisen. The monetary policy objective of the higher reserve ratio has therefore been frustrated. The tendency of banks and other institutions to evade unwelcome official controls by disintermediation is very powerful, particularly when the financial system is liberal in other respects. Such disintermediation is just a form of black marketeering. A mandatory reserve ratio higher than the bank's desired ratio has precisely the same effects as an artificially controlled price beneath the equilibrium level. It does not suppress supply, but drives business away from a familiar and natural outlet to more clandestine channels.

The Committee shows some recognition of these difficulties. Paragraph 4.41 admits that a variable reserve ratio 'restricts the form of the banks' portfolios to some degree and therefore reduces the allocative efficiency of the system' and may 'also adversely affect the competitive position of the banks'; paragraph 4.62 notes that a reserve requirement, through the loss of interest, may act effectively as a tax on the banks. But the Committee's remedy, the payment of interest on reserves, is naive and unsatisfactory. If a near-market interest rate were paid on reserves, the situation would be the exact opposite of that described in the last paragraph, but a variable reserve ratio would still be unhelpful as a monetary policy instrument. The point is that the banks, instead of having an excess supply of reserves, would almost certainly have persistent excess demand. A dollar held at the Reserve Bank enables a bank to lend out many more dollars on which it earns a return above the cost of funds; the possession of a reserve is the key to its profit-maximisation. If banks are to be given a near-market interest rate on reserves, they will gain a profit not only on their loans, but on their reserves too! They will therefore seek to attract as large a reserve as possible, with the desired reserve ratio definitely much above any level so far mandated by the authorities as a control device. Banks' balance sheets, and so their deposits, might grow explosively in such an environment. To prevent this the authorities would have to

fix the rate on reserves much beneath the market rate. Only by this means could they retain leverage over the banks' operations. An implication is that the Committee, if it wants its recommendations to hold water, must necessarily comment on 'the precise determination' of the interest rate on reserves. As we shall see, the present arrangements - in which no interest is paid - are quite sensible.<sup>1</sup>

We seem to be in a dilemma. No matter what the Reserve Bank does, whether it imposes a particular reserve ratio or pays interest on balances left with it, there is liable to be excess demand for or excess supply of reserves. It would be sheer fluke if the mandatory reserve ratio laid down by the Reserve Bank matches exactly the banks' true functional demand for cash. So how can the authorities make progress? How should the Reserve Bank implement monetary control?

The first part of the answer is to emphasise that attempts to exercise monetary control through an official reserve ratio are misguided. There should be no mandatory cash ratio on any financial institution, bank or non-bank, whatsoever. The amount of cash a bank wants to hold depends on the extent of its involvement in money transmission and cheque clearing. As each bank has its own specialised pattern of business, the probability that all banks will have the same desired reserve ratio is negligible. Competitive neutrality is therefore served by having no one ratio applied to every bank. Moreover, the absence of an official reserve ratio avoids the danger that the banking system as a whole will have an excess demand for or supply of cash. This also is in conformity with the requirements of competitive neutrality. The Campbell Report is quite right, in paragraph 4.62, to regard a cash reserve requirement as a

<sup>1</sup> The reader may object that the Reserve Bank could easily prevent the situation described in the text. It should be able to fix the quantity of deposits held with it by the Reserve Bank at its own discretion, so how can a scramble to build up reserves develop? The trouble is that the Reserve Bank cannot fix the deposits banks want to leave with it. If they know they can obtain (say) 13 per cent from the Reserve Bank, they will bid cash from the general public at (say) 6 per cent and then transfer the cash to their Reserve Bank account. The cash in the public's hands is a source of reserves alternative to the Reserve Bank itself. The convertibility of notes into Reserve Bank deposits, and vice versa, is presumably not in question.

## *A New Financial Revolution?*

tax on the banks; it is quite wrong elsewhere to downplay the significance of this tax as a distortion of competitive forces. Aside from the evidence mentioned in a footnote on p.77 that SRD policy has adversely affected the returns on bank shares, it is clear that non-bank financial intermediaries have captured a larger market share in recent years. The building societies, in particular, seem to have grown at the banks' expense. Table 37.1 shows that the permanent building societies' share of housing mortgage debt climbed from 18.9 per cent in 1970 to 33.3 per cent in 1980.

The importance of leaving the banks free from a mandatory reserve requirement is reinforced by the Committee's view that such a requirement should not be extended to non-bank financial intermediaries. Curiously, the Committee's hostility to extension stems from two arguments we have already outlined as of great relevance to the banks themselves. The first is 'the administrative complexity of defining and enforcing the controls, given the variation in the composition of the balance sheets of different intermediaries'; the second is 'the incentive which the controls would provide for the growth of institutions and markets outside the network of controls', combined with 'the obvious efficiency costs' of 'any widespread tendency to "disintermediation".' It is puzzling that the Report should enunciate these arguments in respect of non-bank financial intermediaries considered in isolation and virtually ignore them in respect of competition between them and the banks. This is a conspicuous and unjustified departure from the principle of competitive neutrality.

If the authorities forsook a variable reserve ratio as a monetary policy instrument, competitive neutrality would clearly be strengthened. But we have not yet explained how monetary control could be implemented without it. The prerequisite for such control is that the Reserve Bank have the ability to manipulate interest rates. In most financial systems the central bank has this power as a by-product of its monopoly over the supply of cash reserves. Our brief description of commercial bank operations demonstrated that banks have a functional demand for cash which can be quantified at a particular level at any particular time. If their cash drops beneath this level, they must rebuild their holdings as soon as possible or face the possibility of not meeting obligations to depositors. In this situation they appeal to the central bank for cash assistance. The terms on which help is supplied set interest rates in the short-term money markets. Even if the system has surplus cash, the central bank can enforce its interest rate goals. All it has to

do is to sell paper to institutions in the money markets, withdrawing cash until a shortage has been created. The central bank's sovereignty over interest rates arises because the private commercial banks must have cash and, in the final analysis, the central bank is the only place they can obtain it.

The structure of the Australian payments system, described in Chapter 23, conforms closely with that in other financial systems. The Reserve Bank should therefore have little trouble in manipulating interest rates. The main operational problem is to assess when the banking system is short of cash since it is only then that the Reserve Bank is definitely able to exert sway over interest rates. In Britain, where the banks are not subject to cash ratio control in any meaningful sense, the solution has been for the clearing banks to inform the Bank of England of the size of their target balances.<sup>2</sup> The Bank's money market managers bear this in mind when they conduct open market operations to influence interest rates. But, in principle, the central bank could work without special information. It could tell by inspection of money market rates, aided by its extensive knowledge of banks' past cash management practices, whether the system was short or not.

As many more banks are involved in cheque clearing in Australia than in Britain, arrangements even more informal than those in Britain may be appropriate. Once banks are free to decide for themselves the size of Reserve Bank balances, there is no need to pay interest on them. The possession of a Reserve Bank balance is a prerequisite for full participation in the payments system, including the right to issue cheques. As the Report notes, the provision of payments system facilities 'makes it easier for an institution also to provide related financial facilities . . . particularly so at the retail end of financial markets where the convenience and time saving involved in 'one stop' banking offer powerful attractions.' To be more explicit, banks are compensated for the interest loss on Reserve Bank balances by their competitive muscle in payments services and the resulting access to low-cost sight deposits from the general public.

<sup>2</sup> Banks in Britain must keep a non-interest-bearing balance at the Bank of England equivalent to 1/8 per cent of eligible liabilities. But this has no monetary policy function and is instead regarded as an explicit, if very modest, 'tax' to pay for central banking services. There have been few complaints from the banks about this levy, because it is so small, and no tendency for financial institutions to disintermediate in order to escape it.



Competitive neutrality between banks and non-banks is promoted if financial institutions are allowed, in the light of their own business circumstances, to weigh the cost of non-interest bearing Reserve Bank balances against the competitive benefits which stem from holding such balances.

The Reserve Bank can control interest rates by estimating shadow requirements for the banks and adjusting open market operations accordingly. A prescription for the conduct of monetary policy then follows quickly. When money supply growth is above the target, interest rates must be raised; when they are in line with target, they should be left unchanged; and when they are beneath target, they must be reduced. In practice, the considerations relevant to interest rate policy are more numerous and complicated, including, for example, foreign exchange market developments, but these may be assessed within the broad framework provided by money supply targets.<sup>2</sup>

This approach to monetary control is sometimes confused with interest rate targeting, which the Committee criticises on the grounds that 'nominal interest rates are markedly influenced by inflationary expectations and can give quite ambiguous signals as to what is happening in the real economy'. It may be helpful to draw a distinction between interest rate fixing and interest rate management. Interest rate fixing is the setting of interest rates at a particular level for undisclosed reasons or reasons with no obvious macroeconomic rationale (for example, the central bankers' catch-all 'stability'); interest rate management is the adjustment of interest rates to deviations of the money supply from target. To economists who doubt the validity of the banking multiplier theory of the money supply process, interest rate management is a necessary associate of money supply targets. We explained earlier why the multiplier theory, with its inevitable practical tendency to create excess demand or supply in banks' cash reserves, is unsatisfactory. Our conclusion is that monetary control should be implemented by interest rate management.

To summarise, a variable reserve ratio is liable to have serious discriminatory effects on competition between

---

<sup>2</sup> The thinking here is that interest rate changes affect the credit counterparts to bank deposit growth. The implied theory of the money supply process is very different from the banking multiplier found in textbooks and monetarist writings. For an account of how the system works (if not very well) in Britain, see Congdon, T.G., *Monetary Control in Britain*, Macmillan, London, 1982.

different banks and, more importantly, on competition between banks as a group and non-bank financial intermediaries. It should not be used as an instrument of monetary control, in which role it would be inefficient anyway, because it would conflict with the requirements of competitive neutrality. An important merit of interest rate management as the main technique for regulating the money supply is that it allows full scope for free competition between all kinds of financial intermediary and is, therefore wholly consistent with competitive neutrality.<sup>5</sup>

#### IV. THE INTRODUCTION OF GREATER COMPETITIVE NEUTRALITY

At present the regulatory framework of the Australian financial system is far from ideal. The *Campbell Report* recommends such comprehensive reforms that it is almost impossible to predict how the structure of the system would evolve if they were all carried out. However, similar reforms have been introduced in other countries. Despite the problems of comparison, there are interesting lessons, and perhaps some useful warnings, for Australia.

---

<sup>5</sup> For reasons of space, no comment has been ventured on other balance sheet regulations discussed in the *Report*. Two brief remarks. First, the *Report* is correct to criticise a fixed government security tranche as a requirement on the banks. Nevertheless, the Reserve Bank wants to be confident, for prudential reasons, that banks have adequate liquid assets for sale to it in an emergency. The appropriate ratio is not unique, but depends on each bank's business and should be determined by negotiation between the Reserve Bank and individual banks according to certain recognised criteria. Secondly, the authorised dealers should not be required to invest at least 70 per cent of their portfolios in Commonwealth securities with terms to maturity of up to five years, as suggested on p. 166. The important point is that authorised dealers have sufficient liquid paper to sell to the Reserve Bank for cash whenever banks are withdrawing funds. Such liquid paper can legitimately include commercial bills issued by the private sector as long as they are eligible for rediscount at the Reserve Bank. In Britain, a three-month eligible bank bill is far more liquid - and, in this sense, more suitable as a constituent of discount house assets - than a five-year gilt.

## *A New Financial Revolution?*

The two advanced countries where liberalisation has proceeded most rapidly in recent years have been the USA and Britain. There were certain common features in both cases. First, interest rate regulation and direct restrictions on bank credit were abolished or relaxed. Against a background of obstinately high inflation expectations, the monetary authorities soon discovered that the interest rates needed to curb bank lending were much above those in the more regulated environment of the 1960s and early 1970s. The Campbell Report clearly wishes to see official controls over interest rates removed and so there is every likelihood of a similar outcome in Australia. Credit would become easier to obtain, but more expensive to finance. (The inevitable proviso that interest rates are also subject to macroeconomic policy influences has to be inserted here.)

Secondly, the main losers from financial regulation were the banks. It was on them that the brunt of official intervention tended to fall in the past. Conversely, they have been the main beneficiaries from deregulation. This has been particularly true in Britain. The ending of quantitative lending restrictions in 1971 enabled the banks to enter and eventually dominate the medium-term corporate finance market, at the expense of intermediation via the bond market, while the *de facto* suspension of restraint on mortgage lending in 1980 subjected the building societies, previously almost immune to market pressures, to intense competition. Again, analogous developments are likely in Australia if deregulation proceeds on the lines favoured by the Campbell Committee.

The banks' improved competitive position has had direct implications for monetary policy. Banks have captured a market share from other intermediaries. Whereas bank liabilities are included in broad measures of the money supply, those of other intermediaries typically are not. The result has been accelerated growth of broad money measures, not because of any change in the thrust of monetary policy, but because of the desirable infusion of greater competition into the financial system. The authorities - both the Federal Reserve and the Bank of England, but particularly the latter - have been perplexed by the rapid monetary expansion, as it has often coincided with severely depressed conditions in the real economy. (This is not intended as a criticism of the authorities, whose dilemma has been very understandable.) With inflation persisting, and a wish to play safe in their monetary management, the authorities have kept interest rates extremely high by past standards.

These high interest rates have played havoc with the

traditional relationships between monetary aggregates. Broad money measures, such as M3, include interest-bearing deposits; narrow money measures, like M1 or the monetary base, do not.<sup>5</sup> Because of the better return available on interest-bearing deposits, banks' customers have reduced the proportion of their deposits kept in non-interest-bearing form. As a result, fast growth of M2 in the USA or M3 in Britain has often been accompanied by slow growth of M1. The devotees of the different aggregates have indulged in polemics about what monetary policy 'really' is, to the great amusement of sceptics about monetarism. In Britain, the many advocates of irresponsible financial policies have been delighted. There is a genuine, if remote, danger that money supply targets - and sound money policies more generally - will be scoffed out of economic policy formation because of technical difficulties with the various aggregates.

The Campbell Committee does not want this to happen in Australia. It states without equivocation that, 'Monetary policy - and indeed general economic policy - should have, as one of its principal objectives, the maintenance of long-term price stability.' As a move towards competitive neutrality would almost certainly favour the banks, some once-for-all upward adjustment to the money stock is likely. To avoid the resultant presentational difficulties, the right approach is to estimate in advance how much a particular act of deregulation will increase the money supply. Such estimates can then be incorporated in the formulation of money supply targets. This procedure may seem makeshift and unsatisfactory. Perhaps it is, but even worse would be to pretend that the money supply targets should be immutable and unrelated to institutional developments in the financial system. Inevitably, monetary policy during the transition period will have to be guided by signals from the real economy and the inflation rate, as well as more purely financial indicators. The haziness of monetary policy is a temporary, if unfortunate, cost of progress towards competitive neutrality.

## V. FINANCIAL LIBERALISATION AND ECONOMIC PROGRESS IN A FREE ECONOMY

The financial liberalisation recommended by the Campbell Report would lead to a closer approximation to competitive

<sup>5</sup> In Britain interest-bearing sight deposits are a constituent of M1, but they are small compared to non-interest-bearing current accounts.

## *A New Financial Revolution?*

neutrality. It would end the biased competition between government-supported and private financial institutions; it would put bank and non-bank intermediaries on a more equal footing in their contest for market share; and it would reduce the numerous entry restrictions which prevent financial companies from seeking new business outside their traditional fields of activity. The one major departure from competitive neutrality in the Report's recommendations is its advocacy of a mandatory reserve ratio to be varied according to the needs of monetary policy. This paper has argued that a more desirable, if more radical, arrangement would be to dispense with all balance sheet ratio controls on the banks, including a cash reserve ratio.

Financial liberalisation would enhance competitive neutrality and competitive neutrality would contribute to fair play between rival financial institutions. This is a weighty argument in public debate because of its appeal to equity and justice. The Campbell Report will encounter opposition where its proposals would cause visible damage to an identifiable minority group with considerable political clout. The debate may therefore assume the character of 'fair competition versus vested interests', which should help the Report's reception. However, many public policy questions are decided not by what is to the advantage of the community as a whole, but by a wish to avoid great harm to any particular section. Professor Corden has formalised this political behaviour in terms of a 'conservative welfare function' which attaches low weights to income increases, but very high weights to decreases.<sup>6</sup> If the government does heed the lobbying of those numerically small groups who would lose from financial liberalisation, the gains that would otherwise have been possible for the majority of Australians will never materialise.

In the long run, financial liberalisation should make a valuable contribution to faster economic growth. The social function of the financial system is to allocate scarce resources to their most productive uses. An inefficient and highly regulated financial system cannot perform this role. In the literature of development economics, the concept of 'financial repression' has been advanced to characterise the hindering of profitable investment by politically-motivated interference with financial intermediation.<sup>7</sup> Although

<sup>6</sup> Corden, W.M., *Trade Policy and Economic Welfare*, Oxford University Press, Oxford, 1974, p. 10.

<sup>7</sup> McKinnon, R.I., *Money and Capital in Economic Development*, Brookings Institution, Washington, 1973, p. 15.

intended to apply to underdeveloped countries, there is no doubt that features of financial repression are to be found in developed nations, including the USA, Britain and Australia. If liberalisation continues, these nations may in future be able to enjoy higher rates of economic growth.

Australia is lucky to have been given in the Campbell Report a reasoned agenda for financial reform, probably more comprehensive in scope and more persuasive in content than any prepared elsewhere in the world. It will be even luckier if the Australian government decides to implement the Report's recommendations.

## Further Reading

Brennan, H.G., and Buchanan, J.M., *The Power to Tax*, Cambridge University Press, Cambridge, 1980.

Bresciani-Turroni, C., *The Economics of Inflation*, Allen & Unwin, London, 1937.

Rothbard, M.N., *What Has Government Done to Our Money?*, Rampart College, Santa Ana, 1974.

Hayek, F.A., *Denationalisation of Money*, 2nd Edition, Institute of Economic Affairs, London, 1978.

Simons, H., 'Rules Versus Authorities in Monetary Policy', in *Economic Policy for a Free Society*, University of Chicago Press, Chicago, 1948.

## Index

- Accepting, 6, 7, 16  
Arbitrage, 43  
    currency, 30  
    speculative, 30  
Arrow, K.J., 18  
Asprey Committee, 89  
Australian Industry Development Corporation, 97  
Austria, 3, 8
- Bagehot, W., 66  
Bank of Canada, 33  
Bank of England, 71, 103, 108  
Banks and banking, 66  
    branch, 12  
    bankruptcy, 16  
    central, 33, 39, 104, 105, see also, Reserve Bank of Australia  
    foreign, 30  
    charges, 11  
    cheque clearing, 70, 103, 103  
    deposit insurance, 69  
    deregulation of, 42, 108  
    disintermediation, 102, 104  
    domestic, 12, 68,  
    entry to, 15, 66, 67  
    failure, 12, 39, 66, 67, 69,  
    foreign, 12, 14, 72, 74,  
    entry by, 42, 67, 68  
    licencing of, 79  
    IMU, 6, 7, 8, 11, 16, 18  
    merchant, 7, 11, 12, 13, 42  
    open market operations, 28  
    ownership, 79  
    overdrafts, 14  
    protection of depositors, 69  
    prudential controls, 16, 19, 73, 74  
    reserve ratio, 100, 103  
    variable, 28, 102, 107  
    retail, 12, 73  
    savings, 7  
    State, 19  
    Statutory Reserve Deposit, 100  
Batchelor, R.A., 72  
Bator, F.M., 62  
Bernstein, G.L., 67, 69  
Bhagwati J., 48, 72, 73  
Bison, J.P.O., 47, 51, 53  
Bird, R.M., 84  
Building societies, 7, 11, 12, 42, 81, 108
- Campbell, J.K., 9  
Canada, 26, 74, 33  
Canadian monetary policy, 39  
Carter Commission, 80, 82, 83, 89,  
Coase, R.H., 63  
Commonwealth Banking Corporation, 97, 98, 99  
Commonwealth Development Bank, 97, 98  
Competition, 18, 61-62, 66-68, 73  
    competitive markets, 27, 40-41  
    competitive neutrality, 17, 80, 95-110  
    efficiency in markets, 71  
Competitive neutrality, 17, 80, 95-110  
Congdon, T.G., 106  
Corden, W. M., 110  
Corporate dividend yields, 10  
Covered interest differential, 10, 43  
Credit  
    aggregates, 28  
    bill markets, 68  
    control, 75  
    UK (1971), 13  
    control of interest rates, 28  
    creation of, 8  
Credit cards, 3  
Credit unions, 7, 42  
Currency,  
    debauchment of, 13  
    foreign, 7
- Day of record, 84, 88  
Debt, financing of, 11  
Differential information, 41  
Discounting, 6  
Distributive effects, 19  
Dornbusch, R., 47
- Efficiency, 95, 96  
    economic, 61-62  
    technical, 61-62
- Exchange  
    controls, 42  
    rate  
        flexible, 7, 46, 48  
        flexible peg, 10, 13  
        Reserve Bank as stabilising  
        speculator, 31  
        volatility, 47  
    foreign  
        forward market in, 13, 29, 45, 51  
        market, 12, 13  
        market determination of, 30  
        market, foreign spot, 45  
        forward parity condition, 31  
        forward premium, 46  
        volatility, 48, 53  
        purchasing power parity, 48



## A New Financial Revolution?

- yield
  - covered, 46
- Externality, 17, 18, 26, 41, 62-64, 65, internalisation of, 63
- Fama, E.F., 56
- Federal Deposit Insurance Corporation, 69
- Feldstein, M.S., 88
- Finance companies, 7, 11, 62
- Financial intermediaries, growth of, 8
- Fine-tuning, 18
- Fiscal policy, 29, 33
  - government deficit financing, 44
- Free enterprise objectives, 11, 16, 17
- Frenkel, J.A., 67, 68, 69, 72
- Friedman, M., 39, 69
- Frach, D., 88
- Fullerton, D., 88
- Futures market, 11, 76
- Germany
  - inflation, 3, 8, 21, 31
- Gold, 34, 56
  - standard, 34
- Government-owned
  - enterprises, 17, 19, 96-99
- Graaff, J. de V., 18
- Great Depression, 39, 66
- Griffiths, B., 66, 70, 71
- Hahn, F.H., 18
- Hamburger, M.S., 75
- Haymi, F.A., 3, 18
- Hobson, J.A., 90
- Housing
  - first-time buyers of, 13
  - finance, 11, 12, 13, 15, 92
  - imputed income from, 89, 90
  - mortgages, 13, 82
  - interest, 90
  - owner occupied, 90
  - subsidies, 17
- Income subsidies, 17
- Inflation, 4, 8, 10, 13, 14, 31, 44, 82
  - expected rate of, 46
- Interest
  - on current deposits, 11
  - on government balances, 43
  - on trading bank holdings, 43, 102
  - payment on currency, 44
  - rates
    - controls on, 15, 28, 106
    - housing, 10
    - nominal, 10, 46
    - overdraft, 10, 11
    - parity, 43, 46
    - real, 10, 46
    - regulation of, 106-105, 106
    - volatility, 33, 71-72
- Intaric Report, 10, 11
- Investment
  - foreign, 38, 87
  - inward, 88
  - outward, 88
- Japan,
  - inflation, 21, 31
- Keynes, J.M., 16
- King, A.T., 88
- Koopmans, T.C., 62
- Labour market, 18
- Lender of last resort, 12, 28, 73
- Lenin, V.I., 16
- Levoch, R.M., 72
- Life insurance, 7, 81, 82, 89
- Lucas, R., 32
- McCleure Jr., C.E., 83, 87
- McKinnon, R.I., 111
- Macroeconomics, 26
  - Keynesian, 30
  - neoclassical post-Keynesian, 29
- policy, 14, 25, 28, 60
- Markets,
  - thin, 18
- Meade, J.E., 89
- Meltzer, A.H., 71
- Merchant banks, 7, 11, 12, 15, 62
- Money
  - competitive, 15
  - creation of, 7, 28, 43
  - monetary aggregates, 109
  - monetary legislation, 33
  - monetary policy, 26, 30, 33, 44, 101-107
    - consensus view, 26, 27
    - independent, 49
    - small open economy, 49
    - monetary stabilisation, 25, 26
    - nature of, 3
    - open market operations, 14, 28
    - private provision of, 15
    - standard, 34
    - stock, control of, 29
    - targeting, 14, 15, 27, 43, 100, 109
  - Monopoly, 17, 41
  - Mussa, M., 47
- Neoclassical theory, 31
- OPEC, 31, 41,
- Paternalism, 64
- Phillips curve, 31
- Pigou, A.C., 63
- Prest, A.R., 83, 86
- Primary Industry Bank of Australia, 97, 98
- Prudential controls, 16, 19, 73, 74
- Public goods, 62, 65
- Radclyffe Report (UK, 1959), 9
- Ramaswami, V.S., 68, 72, 75
- Rational expectations, 26, 32
- Reserve Bank of Australia, 7, 8, 10, 12, 13, 18, 15, 16, 27, 35, 43, 44, 103, 104
  - as mutual fund, 36, 35
  - commercial reform of, 55
  - equity portfolio, 37
  - Rural Credits Dept., 97, 98, 104

- Ricardo, D., 90  
 'Round tripping', 70  
 Royal Commission into the Monetary and Banking System, (1936), 9, 39  
 'Rules versus discretion', 14
- Samuelson, P.A., 62  
 Schwartz, A. J., 39  
 Shoven, J.B., 88  
 Simons, Henry, 5  
 Small business, 91, 98  
 Smith, Adam, 6, 7, 14, 16, 41  
 Social costs, 62  
 Stamp duties, 82, 90  
 Stock exchange, 74  
 Superannuation funds, 7, 82, 90  
 Switzerland  
   inflation, 21, 31
- Tariffs, 17, 68
- Tax, taxes, and taxation, 63, 79  
   abuse of power by governments, 8  
   capital gains, 82, 84, 88  
   company, 82, 83, 85, 87  
   credits, foreign, 87  
   division 7, 81  
   flow of funds, 89  
   forward shifting, 84  
   implicit, 82  
   imputed income from housing, 89  
   income  
     marginal rates, 17  
     indexation, 82, 90  
     integration, 81, 82-89  
     inward and outward investment, 87-88  
     loss allocation, 84  
     loss offset, 81  
     preferences, 88  
     shifting, 83  
     withholding 82, 85, 88  
 50/20 Rule, 13, 89  
 Transaction costs, 63, 64
- Uncertainty, 73  
 Unemployed, 13  
 United Kingdom, 65, 67, 70, 80, 88, 90,  
   91, 108  
 United States of America, 8, 63, 108
- Wage and price controls, 30  
 Wage rate rigidity, 31  
 Whalley, J., 88  
 Wilson Report, (U.K., 1980), 9  
 Wood, G.E., 68, 73

## CIS PUBLICATIONS IN PRINT

### READINGS

1. *Wage-Price Control, Myth & Reality*, edited by Sudha R. Shenoy. Contributors include: Robert Schuettinger, Samuel Brittan, Peter Lilley, Horst Mendershausen, Malcolm Fisher, Michael Parkin, Michael R. Darby, Jackson Grayson, Lee Eckermann, Sudha Shenoy, Peter Samuel and Milton Friedman; with a Foreword by C.G.F. Simkin.

275 pages ISBN 0 9596485 0 X \$5.95

2. *Rent Control: Costs & Consequences*, edited by Robert Albon. Contributors include: Robert Albon, Steven N.S. Cheung, Michael Cooper, H.V. Evatt, Milton Friedman, Helen Nelson, Ross Parish, Sven Rydenfelt, David Stafford, George Stigler and R.H. Webster.

256 pages ISBN 0 9596485 7 7 \$9.95

### RESEARCH STUDIES IN GOVERNMENT REGULATION

1. *Domestic Airline Regulation: The Australian Debate* by Michael G. Kirby examines the issue of domestic airline regulation in Australia, especially as it relates to matters such as monopoly, air safety, the Two-Airline Policy and government ownership of an airline.

120 pages ISBN 0 9596485 9 3 \$5.50

2. *Rationalising Rustic Regulation* by E. Sieper examines the many types of intervention by government in the rural industries. Rather than seeing these interventions as necessarily serving the 'public interest' or some notion of economic efficiency, Sieper examines them in a distributional framework to see who really does benefit.

96 pages 0 949769 02 9 \$5.50

### POLICY MONOGRAPHS

1. *On Buying a Job: The Regulation of Taxicabs in Canberra* by Peter Swan, discusses the consequences of restrictive taxicab licence provision in the Australian Capital Territory.

20 pages ISBN 0 9596485 5 0 \$1.50

332-09

FUS [570]

OCCASIONAL PAPERS

1. *Liberty, Equality & Unhappiness* by Lauchlan Chipman reproduces the first Eddy Memorial Lecture sponsored by the Workers' Educational Association.  
 20 pages                      ISBN 0 9596485 1 8                      \$1.50
2. *Social Justice, Socialism & Democracy* by F.A. Hayek brings together three lectures delivered by Professor Hayek during a visit to Australia in 1976. Included is a biographical essay by Roger Randerson.  
 61 pages                      ISBN 0 9596485 3 4                      \$3.95
3. *The Profit Motive* by Antony Flew, is the paper delivered at the Centre's Inaugural Occasional Seminar held in August 1980.  
 20 pages                      ISBN 0 9596485 8 5                      \$1.75
4. *Taxation, Inflation and the Role of Government* by Milton Friedman with comments by Michael Porter, Fred Gruen and Don Stammer, is the proceedings from the Centre's second Occasional Seminar.  
 52 pages                      ISBN 0 949769 00 2                      \$3.50
5. *The Rhetoric and Reality of Income Redistribution* by Gordon Tullock discusses the various motives behind income redistribution schemes and calls for a little honesty in the rationalisations used to explain such schemes.  
 28 pages                      ISBN 0 949769 08 8                      \$2.50
6. *Liberty, Justice and the Market* by Lauchlan Chipman demonstrates that contrary to orthodox opinion, the free market is not only the most efficient way of organising the economic affairs of society, but it does so in a manner consistent with fundamental principles of justice and freedom.  
 20 pages                      ISBN 0 949769 05 3                      \$2.00

## **A NEW FINANCIAL REVOLUTION?**

An international review of the Campbell Report

Malcolm Fisher (ed.) ● A. R. Prest ● Michael Parkin  
Geoffrey E. Wood ● John F. O. Bilson ● Tim Congdon

The Report of the Committee of Inquiry into the Australian Financial System (the Campbell Committee), released in November 1981, is probably the most important blueprint for financial reform in the history of Australia.

The many reforms that the Report recommends will ensure that it remains centre-stage in the debate on financial matters for years to come. To assist in this debate and to add some independent and expert commentary, the Centre for Independent Studies commissioned six renowned economists from the United Kingdom, Canada, the United States and Australia to review a number of aspects of the Report. None of the authors was in any way involved with the Inquiry and so, by examining carefully the principles underlying financial reform, they add a detached and valuable perspective.

**A New Financial Revolution?** is an indispensable aid in interpreting the many aspects of the Campbell Report. Much of the commentary this book contains can be easily assimilated by both specialist and layman.

**ISBN 0 949769 04 5 ISSN 0156-7306 \$7.00**

**CIS READINGS 3**