Symposium on the Wallis Report: Introduction

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The deregulation of the exchange rate and of the financial system in the early 1980s are, without doubt, among the most important influences shaping the post world war Australian economy. The Report of the Financial Systems Inquiry (The Wallis Report), published in March 1997 offering as it does a reassessment of those events, as well as a chance to implement further reforms, has the potential to be of great significance in shaping the future of the economy well into the next century.

This symposium assesses that report. Before doing so, it is important to set the scene by looking at the preceeding major change to the financial system. This is done both in the paper by Nevile, which examines the forces resulting in the deregulation of the exchange rate and of the financial system; and in the paper by Kearney which review subsequent changes. The paper by Nevile is the result of research, which involved interviews with most of the important players. It examines the stages of the debate which eventually led to the floating of the exchange rate, and the easing of regulation within the financial sector. Although no one doubts the necessity of floating the Australian dollar, given the international economic environment, the speed at and the degree to which the Australian government did it surprised many, including members of the Campbell Committee, who expected a much more gradual change.[1] The paper contains many important revelations which give clues as to why it all proceeded so fast. It reviews the debates and discussions of the time to ascertain where the impetus for deregulation was coming from. In doing so, it illustrates the cliche that nothing is as simple as it seems. The forces pushing for deregulation arose from a coalition of political, business and academic interests. Underlying these were changes in ideology driven by the changes in the economy, in

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particular in the financial sector. The paper is an excellent example of 'political economy'. It shows how major political and economic decisions are the result of a combination of academic ideas, political interests and underlying economic forces. These don't fully determine outcomes, as the human factor has a powerful input. In the case of the exchange rate deregulation, the human factor was provided by the Prime Minister's intervention sweeping aside a long reasoned debate with an aside which defined the main policy agenda.

The setting up of the Campbell Inquiry was the result of compromise, as were its results and subsequent implementation. The paper argues that, in the end, economic and political forces coalesced in providing the outcome. Economic in the sense that regulation in an increasingly deregulated world would have caused serious problems for the Australian economy. Political in that the Hawke government used it to signal to the market that it was a 'responsible' economic manager, in an attempt to distance itself from the Whitlam Labor government. However, the speed of deregulation still surprised many!

As a result of these deregulations, the Australian economy, especially the financial sector, has undergone significant restructuring. Given the importance of finance for the health of an economy, it was important that these changes be evaluated, and further changes to improve the system be implemented. This was the purpose of The Financial System Inquiry, appointed in 1996 chaired by Stan Wallis, whose report is the subject of the symposium.

The fundamental principle underlying the Report is a belief in the ability of unregulated markets to deliver the goods, except in the explicit case of market failure.

Jeffrey Carmichael, a member of the Wallis Inquiry, provides an overview of the philosophical foundations of the Report. He argues that the Report attempts to 'streamline regulation' making it more efficient. The need for reform comes from existing inefficiencies and from anticipated changes in international financial markets which the current system cannot adequately deal with. The Report found that many of Australia's banking practices were inefficient by international comparison. To alleviate this problem, they suggested changing regulation, in particular removing duplication and fragmentation by rationalising regulatory bodies. They argued that long run trends leading to increased globalisation, competition and efficiency of financial services, would conflict with the current regulatory framework. Within this context, the Report identifies four main sources of market failure, and suggested Regulatory bodies to deal with each. The first

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two, 'anti-competitive behaviour' and 'market misconduct' are features of all markets. The second two, 'information asymmetry' and 'systemic instability' are more relevant to financial markets.

Information asymmetry occurs within financial markets when consumers are unable to adequately assess risk. Systemic instability is the result of third party risk, where the failure of one financial institution to honour its financial promises causes more general panic which results in distress to third parties. This contagion effect results when problems experienced by one financial institution are generalised by consumers, due to information asymmetry, to other sound institutions. The most obvious example of this is runs on banks.[2]

The main recommendation of the Report was a restructuring of the regulatory structure of the financial industry. To replace the old regulatory structure, where regulation was based on institutions, the new framework would apply regulation on the basis of the functions performed by the financial instrument. To this purpose the main recommendations were for a streamlining of the regulatory bodies. The existing Australian Competition and Consumer Commission, which oversees general regulation of competition, is to include the financial sector within its terms of reference. To regulate market misconduct, the Corporations and Financial Services Commission is to be established; to overcome information asymmetry, especially with respect to risk, the Australian Prudential Regulatory Authority (APRA) would maintain prudential regulation of the financial system; while the Reserve Bank of Australia would be responsible for systemic stability.

The two papers by Kearney and Hogan & Sharpe are less than propitious in their analysis of the Report. Both papers are critical of the Report's lack of detail, arguing that the specifics behind the general analysis are never spelt out. The Report is based on many assumptions about the working of the financial system, which have not been tested to determine their applicability. In particular, there is an underlying implicit assumption of the large positive net benefits of deregulation, even though these are never explicitly discussed.

With respect to the formal recommendations, Kearney expresses two main concerns. Firstly he notes that governments are 'better at enacting legislation than they are at monitoring and evaluating its short-run and long-run outcomes'. Since the suggested changes may result in many unintended consequences there needs to be a monitoring of the outcomes of the proposals in line with some well specified performance indicators. Secondly, he is worried about the problem of coordination between the

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different regulatory bodies. This point is reinforced by Hogan and Sharpe who highlight the contradiction between the role of the Reserve Bank in maintaining systemic stability, and moving the prudential supervisory role to the APRA, who are responsible for dealing with the failure of financial institutions to meet obligations.

Hogan and Sharpe, while sharing many of Kearney's concerns, worry that the Report provides little justification for the changes in regulatory bodies, and, in particular, the supposed benefits from the creation of a 'mega-prudential regulator', the APRA, are merely asserted. This is both with respect to the reduced costs arising from economies of scale, and from the benefits supposed to follow from extending the reach of prudential regulation. The analytical basis for this is the concept of convergence which underlies much of the analysis of the Report. According to the Report, convergence is the result of the evolution of financial instruments of different institutions in ways which make them more and more similar to each other. This means that differences between financial institutions are becoming blurred, which is the basis for the Report's recommendations of regulation by function rather than institutions. However, convergence can also be seen as the development of new financial instruments as a way of increasing the range of choice, therefore reflecting greater 'completeness of financial markets'. As a result, it is likely that there will be an increase in disintermediation as funds shift out of the regulated financial sector into unregulated markets.

Given the undoubted importance of the financial system, the overall conclusions to be drawn from the papers in this symposium is that more caution is needed. There is general concern that the costs and benefits of the proposed changes have not been adequately analysed, and that if any changes go ahead, their effects need to be carefully monitored.

Notes

1. Grattan (1994)
2. See Neal (1997)

References

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