FINANCIAL Deregulation AND THE MONETARY
TRANSMISSION MECHANISM OF THE
AUSTRALIAN ECONOMY

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A thesis submitted in fulfilment of the requirements for
the degree of Doctor of Philosophy

December, 1995

Awarded 1996
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ABSTRACT

The purpose of this thesis is to evaluate the changes that have occurred to the Australian monetary transmission mechanism as a result of deregulation of the financial sector. This thesis provides new insight into three main areas.

First, an asset market model, in which the supply of assets is endogenous, is specified and estimated for the Australian financial sector. The estimation of this model provides an assessment of how the process of financial deregulation has changed the relationships within financial markets in which the Reserve Bank is primarily reacting to asset market conditions, implying that the supply of money is endogenous. In this model, as well as being affected by demand and supply in the markets for financial assets, the exchange rate is affected by fundamentals such as relative expected secular inflation and unexpected changes in the trade balance. This treatment of the expectations mechanism in the foreign exchange market allows for exchange rate overshooting as observed in flexible exchange rate regimes.

Second, we evaluate the responses of the model to the banking sector's choices of the combination of assets and liabilities in the post-deregulation period, using a portfolio-loan approach to monetary changes. This approach embodies a) the post-Keynesian view of the implications of asset substitutability for the money supply, and b) the new Keynesian view of the banking system's response to the increased riskiness of credit, regarding credit rationing in the underwriting process for new risky assets, equities. In the portfolio-loan approach, the model of the monetary transmission mechanism is viewed in the spirit of a variant of the textbook IS-LM model, which incorporates the credit rationing hypothesis in the interest rate-GNP relationship. In this model bank controls on the loan rate under credit rationing is analysed by some rules under which loan rate controls depend on some specific historical data. Further, disequilibrium modelling of the demand and supply of loans provides estimation of the amount of credit rationing. In the model under discussion variation in the quantity of loans caused by changes in bank reserves makes monetary policy more expansionary than in the standard IS-LM model.
Another important aspect of this analysis is the implication of credit rationing for portfolio investors’ preferences for securities with different terms to maturity. In this analysis portfolio investors’ incentives to borrow from the banking sector play a pivotal role in the linkages between the bank loan market and the financial markets for securities of different maturities. The loan rate in a rationed credit market reflects banks’ proxies for the expected rate of return and default risk of the average projects. If there is no regulation in financial markets, it is more likely that the proxies conform to the actual rate of return on the average projects. In this thesis we evaluate the relevance of the credit rationing approach in a model of the term structure of interest rates in which credit rationing provides portfolio investors with the ability to adjust to the actual rate of return on their portfolios. This requires that portfolio investors expectations in financial markets should be model consistent, or rational.

Third, in a reduced-form equation we evaluate the relevance of the credit rationing hypothesis by examining its tightening impact on real output, implying that in the credit-rationed state the effects on output of higher levels of aggregate demand relative to its trend values are depressed. We also examine the difference to the contribution of monetary shocks to output fluctuations when the economy’s credit constraint is binding.

The Australian post-deregulation experience provides strong support for the credit rationing hypothesis, and the proposition that the output effects of credit rationing is of macroeconomic importance. The results show that Australian banks act, in the aggregate, as though they ration credit by non-price means. Also, there is evidence that credit rationing in the post-deregulation period provides portfolio investors with economic information concerning the actual rate of return on the average portfolio in the Australian market for short-term securities. In addition the output effects of credit rationing are shown to be significant, and the contribution of monetary shocks to output fluctuations is significant when a tightening of monetary policy is associated with the credit-rationed state.