

**Standard Bearers for the Markets:
International credit rating agencies, new
actors in politics and public policy**

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Introduction

After the recent round of State Budgets The Australian newspaper editorialised that if Labor state treasurers were any guide, “we are all fiscal conservatives now”¹ The comment particularly referred to South Australian Treasurer Kevin Foley’s self imposed “mission” of restoring the State’s triple-A credit rating. After his 2003 budget Foley had suggested that a triple A rating from international credit rating agencies “should be the goal of every treasurer”². His enthusiasm and commitment to regaining the top rating was undiminished in 2004 leading to the media’s description of a “grand obsession” in pursuit of a “fiscal holy grail”³ Foley is not alone in this view, and his conviction that obtaining the highest possible rating is a mark of successful government is also shared by his colleagues in each of the other States. The Premier of NSW, for example, listed the maintenance of his states triple A rating as a major achievement in his election day message to the voters at the NSW poll last year.⁴

The States began to engage with international credit rating agencies and start the process of “getting rated” in the 1980’s as they sought to enter international financial markets. It was apparent at that time that the external scrutiny inherent in the rating process had political implications, particularly in the way governments were able to represent their financial policies to the Parliament and to the electorate. However, with the benefit of hindsight, it is clear there were deeper and more far reaching changes occurring and that as part of the price for entering financial markets state governments were being required to accept the disciplines, principles, and ideology of the market.

It is easier now to recognise the shape and extent of the changes that have occurred as politicians and administrators combined to transform the public sector as part of a drive to make the Australian economy more internationally competitive.⁵ The practical consequences have ranged from the growth of “managerialism”, with its emphasis on contractual arrangements and private sector styles of management, to the development of National Competition Policy, with its encouragement of outsourcing and privatisation, from the

¹ "Responsible, but Unadventurous," *The Australian*, 28 May 2004.

² AAP, "AAA Credit Rating an Achievable Goal: Foley," *AAP General News (Australia)*, 29 May 2003.

³ Michael McGuire, "Treasurer Closer to His Fiscal Holy Grail," *The Australian*, 28 May 2004.

⁴ Bob Carr, "Committed to Renewal - NSW Election 2003," *Daily Telegraph (Sydney)*, 22 March 2003.

⁵ Herman Schwartz, "Small States in Big Trouble: State Reorganisation in Australia, Denmark, New Zealand, and Sweden in the 1980s," *World Politics* 46, no. July (1994). p.531. Schwartz outlines the argument that the state, particularly the welfare state, was the largest single part of the non-tradable sector, rising costs within which decreased the competitiveness of tradable firms. See also John Wiseman, *Global Nation? Australia and the Politics of Globalisation* (Cambridge: Cambridge University Press, 1998). who suggests that during the Hawke governments of the 1980s, “Competitiveness was to become both the diagnosis and the cure for all kinds of economic and social ills, with the choice of remedies underpinned by increasingly dominant ‘economic rationalist’, neo-liberal economic policies”

greater centralising of control over spending, to the embrace of accrual accounting. In a wide range of areas traditionally seen as the sole province of the public sector, (for example, health and education, including the universities) increasingly the strategy has been to commodify the service so that it is possible to distribute or allocate it through the market process.

The focus of this paper is the part played by credit rating agencies in creating the circumstances that have led to these policies being adopted. This does not presume a direct causal link. But rather, in a economy being transformed by globalisation, the role of credit rating agencies in the critical task of funding the public sector put them in a position in which they have become, the standard bearers for the market and the philosophy which underpins it across the whole range of public sector activity.

The paper argues that the international credit rating agencies have had, and continue to have, a major role in shaping the public policy of state governments, and the management of their public sector, through the central part they play in the process by which those governments' raise funds. In effect they have become both part of the broader regulatory structure of public administration and the means by which the requirements of global financial markets are transmitted to the public sector. They are an unseen but ever present "participant" in the business of making policy.⁶

Deregulation in both domestic and international financial markets during the 1980s created attractive opportunities for the States to raise funds. However, they were also pushed towards the markets by the Commonwealth Government as part of an overt strategy to restrain State borrowings. The Commonwealth's Budget Papers record that changes to Loan Council borrowing arrangements throughout that period were designed to "facilitate financial market scrutiny of public sector finances via better reporting and so make jurisdictions more accountable to the markets".⁷ These new financial arrangements have been described more colourfully as having "exposed the States' soft underbellies to the sharp teeth of the CRAs, who immediately began to rate and re-rate the States with some enthusiasm."⁸

⁶ H. K. Colebatch, *Policy*, 2nd ed. (Buckingham: Open University Press, 2002). see the discussion pp 23 – 30. In the terms Colebatch uses, rating agencies have both 'authority' and 'expertise' as the basis for 'participation'.

⁷ "Budget Paper No4: Commonwealth Financial Relations with Other Levels of Government 1993-1994 Pp90 of 1993," (Canberra: AGPS, 1993).P. 67. See also K. T Davis, "Public Sector Securities Market," in *The Australian Financial System: Evolution Policy and Practice*, ed. M K Lewis, and R H Wallace (Melbourne: Longman, 1997). p.436

⁸ David Hayward, and Mike Salvaris, "Rating the States: Credit Rating Agencies and the Australian State Governments," *Journal of Australian Political Economy* 34 (1994). p.20

Today it would appear that the rating agencies have moved from being an instrument of, or means to entry into financial markets, to a significant arbiter of what comprises good government.

This paper will look at how the rating agencies came to occupy this role. I will argue that the changes that gave rise to the increased importance of credit rating agencies are better understood when seen the context of economic globalisation generally, and globalisation of financial markets in particular. In Australia the response to globalisation drove the process of financial deregulation, which began in the mid 1970s and rapidly gathered velocity during the first Hawke Government, particularly following the floating of the Australian dollar.

These changes will be discussed within the context of what has been described as a system of "new global finance"⁹ that developed as a result of globalisation, and the public role that credit rating agencies play within that system. In particular, the way in which they act as private makers of public policy, a role in which they "help to privatize policy making, narrowing the sphere of government intervention"¹⁰

The paper concludes that this new environment has significant implications for the development of public policy and the management task within the public sector. It also gives rise to a further set of issues surrounding the relationship between governments and the rating agencies. In particular, how the threat of a downgrade or promise of an upgrade has been used by governments as part of their political communication strategy both externally to the electorate and internally to the public sector. . And what of the agencies themselves, how valid is their approach and methodology?¹¹

While the focus of this paper is the rating process and the development of financial policy in the 1980s and 1990s as it affected Australian state governments, my view is that these issues are not limited to Australia. Indeed events in our region suggest that many states are facing internal change to

⁹ Timothy J Sinclair, "The Infrastructure of Global Governance: Quasi-Regulatory Mechanisms and the New Global Finance," *Global Governance* 7 (2001), Timothy J Sinclair, "Private Makers of Public Policy: Bond Rating Agencies and the New Global Finance," in *Common Goods. Reinventing European and International Governance*, ed. Adrienne Heritier (Lanham: Rowman & Littlefield, 2002), Timothy J. Sinclair, "Passing Judgement: Credit Rating Processes as Regulatory Mechanisms of Governance in the Emerging World Order," *Review of International Political Economy* 1, no. 1 Spring (1994), Timothy J. Sinclair, "Reinventing Authority: Embedded Knowledge Networks and the New Global Finance," *Environment and Planning C: Government and Policy* 18 (2000).

¹⁰ Sinclair, "The Infrastructure of Global Governance." P441

¹¹ The use of comments by rating agencies to pursue a particular political agenda is discussed in Hayward, "Rating the States.", which also raises some questions concerning the agencies methodology. Andrew Fight, *The Ratings Game* (Chichester: John Wiley and Sons, 2001). has a more extended, and damning critique of the way the agencies operate. The role of ratings in shaping the "image" of a government is discussed in Michael Kunczik, "News Media, Images of Nations and the Flow of International Capital with Special Reference to the Role of Rating Agencies," *The Journal of International Communication* 8, no. 1 (2002).

systems of government and administration as they engage with the global economy.

THE IMPACT OF GLOBALISATION: THE CENTRAL ROLE OF FINANCE

It is not difficult to find the term 'globalisation' being used by politicians to explain a change that has occurred, or justify an action that needs to be taken. But there is less understanding of how "globalisation" impacts on politics in a practical sense, or the means by which it affects the way the public sector is structured and managed. ¹²

This lack of precision stems largely from the vagueness surrounding the term itself. Globalisation has been variously described as being at risk of becoming "the cliché of our times: the big idea which encompasses everything from global financial markets to the Internet"¹³, and as replacing the cold war as the most overused and under-specified explanation for a variety of international events. It has been used to describe an historical epoch, an economic phenomenon, the triumph of American values and a sociological and technological revolution.¹⁴

Within the literature of politics and political economy the concept occupies "contested territory".¹⁵ That contest has given rise to continuing skirmishes ranging from how best to characterise the concept itself, whether in fact it does represent a new set of circumstances significantly different from past experience, the extent and nature of its impact on existing systems of government and democratic processes within nation states. Following on from that, can globalisation permanently reshape and restrict the political process, or can politics reassert itself and in turn "tame" globalisation.

The nature of the debate, and the vagueness of definition of the term itself, has given rise to a focus on typologies, taxonomies and categorisations. David Held and his colleagues distinguish between *the hypoglobalisers, the sceptics, and the transformationalists*¹⁶. Anthony Giddens more simply identifies

¹² An exception as regards the political environment at the national level is Tom Conley, "The Domestic Politics of Globalisation," *Australian Journal of Political Science* 36, no. 2 (2001). pp223-246

¹³ David and Anthony McGrew Held, David Goldblatt, and Jonathon Perraton, *Global Transformations: Politics, Economics and Culture* (Stanford: Stanford University Press, 1999).p.1

¹⁴ Richard Higgott, and Simon Reich, "Globalisation and Sites of Conflict: Towards Definition and Taxonomy," (University of Warwick Coventry: Centre for the Study of Globalisation and Regionalism, 1998). P.2

¹⁵ Peter Dicken, *Global Shift: Transforming the World Economy* (London: SAGE Publications, 1998). P.79, also Mark Beeson, "Globalisation and International Trade: International Economic Policies and the 'National Interest'," in *The Politics of Australian Society: Political Issues for the New Century*, ed. Paul Boreham, Geoffrey Stokes and Richard Hall (Longman, 2000). P, 214 Dicken and Beeson come from different sides of the contest.

¹⁶ Held, *Global Transformations: Politics, Economics and Culture*.p.3

sceptics and radicals,¹⁷ while John Wiseman attempts to capture some of the ideology and fervour of the political debate by suggesting a differentiation between *fanatical supporters, progressive competitors, conservative sceptics, and socialist challengers*.¹⁸

While typologies are sometimes useful as a means of establishing a conceptual picture of an overall debate, as with all broad categorisations nuance is often lost in the interest of neatness. Similarly, unhelpful is the contradictory extremes around which the arguments are often arranged with unambiguous declarations of a soon to be borderless world at one end of the spectrum, opposed by claims that little change has in fact occurred beyond a degree of increased internationalization which merely mirrors what has gone before.¹⁹

However, regardless of whatever concept or theory particular commentators adopt, the rapid growth of financial markets is usually of central importance.²⁰ Susan Strange brought focus to the debate on the creation of credit within the financial system with her description of the western financial system as “rapidly coming to resemble nothing as much as a vast casino” in which all of us are involuntary engaged in the days play.²¹ Analysing the uncertainty evident in the international financial system in the 1980s she identified three key sets of prices, the price of currencies, (exchange rates) the price of credit, (interest rates) and the price of oil. Each was inherently unstable and in turn fed uncertainty and volatility in the others. The common factor linking them was the international financial system, “the rootstock from whose disorders stem the various problems which affect the international political economy just as blight disease or mildew attack the different branches of a plant”.²²

Strange highlighted the neglect of credit creation and changes to the global financial structure suggesting that supply of credit was as important as its demand. Many of the arguments about the extent, nature and impact of globalisation fall down because they focus on physical transfers across borders including the transfer of money in terms of direct foreign investment. Strange believed more focus was needed on the fundamental changes that

¹⁷ Anthony Giddens, *Runaway World: How Globalisation Is Shaping Our Lives* (London: Profile Books, 1999). p.7-8

¹⁸ Wiseman, *Global Nation? Australia and the Politics of Globalisation*. p.18

¹⁹ Examples of the first are the works of Kenichi Ohmae, *The Borderless World: Power and Strategy in the Interlinked Economy* (New York: Harper Business, 1990), Kenichi Ohmae, *The End of the Nation State: The Rise of Regional Economics* (New York: Free Press, 1995).. The opposing view is represented by Paul and Grahame Thompson Hirst, *Globalization in Question: The International Economy and the Possibilities of Governance*, Second Edition ed. (London: Polity Press, 1999). also Robert Wade, "Globalization and Its Limits: Reports of the Death of the National Economy Are Greatly Exaggerated," in *National Diversity and Global Capitalism*, ed. Suzanne Berger, and Ronald Dore (London: Cornell University Press, 1996).

²⁰ John Quiggin, "The Fall and Rise of the Global Economy: Finance," in *Globalisation. Australian Impacts*, ed. Christopher Steil (Sydney: UNSW Press, 2001).p 19

²¹ Susan Strange, *Casino Capitalism* (Oxford: Basil Blackwell, 1986).

²² Strange. p.10

had taken place in the volume and nature of credit created by the market economy.²³

There seems little doubt that the term globalisation can be correctly applied to financial markets in the period following the collapse of Bretton Woods.²⁴ Along with the explosive growth in financial derivatives and a growing range of exotic products, foreign exchange trading has creating a money economy which dwarfs the “real’ economy. These changes have in turn been accompanied by technological change which has had the effect of “catalyzing and accelerating other changes: dramatically reinforcing economic change and a range of structural development in the wider economy”.²⁵

In this process of change the role of the state was at times equivocal, at least in the case of particular nation states who saw the opportunity to gain advantage for themselves or as a minimum ensure no disadvantage. For example, Eric Helleiner argues that “states” have in fact supported financial globalisation and have in general been far more content to liberalise monetary controls than trade barriers.²⁶

NEW GLOBAL FINANCE AND THE CREDIT RATING AGENCIES

Randall Germain argues that the “motor force” for the global explosion of the availability of private credit through diverse global sources has been the “progressive privatization of the global credit system” after the end of the “quasi-public international organisation of credit” represented by Bretton Woods.²⁷ It was a change which government’s were hard pressed to control so that it became increasingly difficult to exercise public power over financial markets.

Instead private monetary agents have become dominant over public authorities as the balance between the state and market authority was transformed with the state far less involved in the creation and allocation of credit. As a consequence “the power of private monetary agents increasingly

²³ Susan Strange, *The Retreat of the State: The Diffusion of Power in the World Economy* (Cambridge: Cambridge University Press, 1996).

²⁴ Eric Helleiner, "From Bretton Woods to Global Finance: A World Turned Upside Down," in *Political Economy and the Changing Global Order*, ed. R Stubbs, and Geoffrey R. D. Underhill (London: Macmillan, 1994). P.163 Helleiner describes the growth of financial markets as the “unplanned child” of Bretton Woods.

²⁵ Phillip G Cerny, "The Dynamics of Financial Globalization: Technology, Market Structure, and Policy Response," *Policy Sciences* 27 (1994). p319-320

²⁶ Eric Helleiner, "Explaining the Globalization of Financial Markets: Bringing States Back In," *Review of International Political Economy* 2, no. 2 (1995). also Eric Helleiner, "Freeing Money: Why Have States Been More Willing to Liberalize Capital Controls Than Trade Barriers.," *Policy Sciences* 27, no. 4 (1994).

²⁷ Randall D Germain, *The International Organisation of Credit. States and Global Finance in the World Economy* (Cambridge: Cambridge University Press, 1997). The argument developed in these paragraphs is based on Chapter 4 The era of decentralized globalization.

shapes the context of state action within the international organization of credit"²⁸

The dominance of the market potentially compromises the 'embedded' nature of postwar liberalism. It limits, "The ability of states to maintain support for social welfare proportions of state expenses" which in turn has become "dependent on the willingness of private monetary agents to buy and hold public securities"²⁹

This willingness is determined by criteria which are based around profit and maximization of market share. "Access to international credit will come ultimately to depend upon the fulfillment of these criteria, to the detriment of any number of public or private needs which fall under the category of basic or social needs"³⁰

The process of change has removed governments from the means to control the creation of credit and the criteria by which credit can be obtained. However, in this new global financial system there are new private regulatory structures which determine the conditions on which credit is obtained. Central to how they have developed in prominence and authority is the process of "disintermediation" or direct financing.

The work of Timothy Sinclair has formed the basis for the idea of the new global finance; a concept he uses to describe the consequences for global capital markets of the period of globalisation since the 1970s. The differentiating feature of the new global finance is the process disintermediation by which borrowers and lenders have moved away from the traditional financial intermediaries, such as banks, to transact directly with each other through financial markets. This has heightened the importance of other non-bank financial institutions such as mutual funds. In short the process removes the traditional bank as the middleman in the process of creating credit.

In a traditional bank mediated transaction a bank undertook to understand and assume risks on the money it lent on behalf of its depositors. In the case of direct financing that risk is more likely to be assumed directly as the depositor becomes a lender. The changing role for banks presents a problem for suppliers and users of funds.³¹

²⁸ Germain. p.25

²⁹ Germain. p163 and p.164

³⁰ Germain. p.132

³¹ Timothy J. Sinclair, "Between State and Market: Hegemony and Institutions of Collective Action under Conditions of International Capital Mobility," *Policy Sciences* 27 (1994), Sinclair, "Passing Judgement: Credit Rating Processes as Regulatory Mechanisms of Governance in the Emerging World Order." p.136

Seabrooke³² offers a different definition which places stress on disintermediation as a micro economic process within the international political economy and emphasizes the importance of direct financing. He anticipates that the traditional banks have themselves adapted and embraced financial innovation to regain their pre-eminent role in the financial system. Nevertheless his argument is similar to Sinclair's, "As investors act directly in finance market disintermediation eliminates the ' middlemen ' and promotes the use of financial innovations to combat risks".³³

Credit rating agencies are increasingly important institutions within the new global financial system characterised by a move to disintermediation or direct financing. It has heightened their role and their visibility as organisations with the capacity and knowledge to provide globally comparable information on risk. This has been further enhanced by the complexity of markets and their global geographic scope. The economies of scale they can capture have made them a viable alternative to traditional in-house research.³⁴

While credit rating agencies have come to greater prominence over the past twenty years, they have a longer history, particularly in the United States. They developed from mercantile credit rating companies in the first half of the 19th century that rated the ability of merchants' ability to pay their accounts. They first expanded into rating securities in 1909 when John Moody started to rate US railway bonds.³⁵ Credit rating agencies occupy a formal role in the US through the designation of the major agencies as National Registered Statistical Rating Organisations (NRSROs). Various pieces of legislation require that mutual organisations, such as pension funds, cannot invest in any security that is not rated as "investment grade" by an NRSRO. In the US the reliance on ratings extends to virtually all financial regulators, including the public authorities that oversee banks, thrifts, insurance companies, securities firms, capital markets, mutual funds, and private pensions."³⁶

These rules provided the context for the South Australian government's first contact with credit rating agencies when SAFA, its central borrowing authority, sought to gain access to the US commercial paper market for US denominated short term funds in 1984. This required SAFA to obtain a rating

³² Leonard Seabrooke, "The Political Economy of Direct Financing: Us Structural Power in International Finance" (MA, Flinders University of South Australia, 1998).

³³ Seabrooke. p1

³⁴ Fight, *The Ratings Game*. p.10

³⁵ Richard Cantor, and Frank Packer, "The Credit Rating Industry," *Federal Reserve Bank of New York Quarterly Review* 19, no. 2 (1994). p.2

³⁶ Cantor and Packer. p.5

from the two major US rating agencies Moodys and Standard and Poors so that institutions could legally buy their securities.³⁷

As financial markets became global so too did the US credit rating agencies expand into those markets. While their value to US investors was recognised by operators in other markets, clearly their growth also reflected the “structural power” of the US and the “head start” it gave US financial intermediaries.³⁸

Sinclair uses the term “embedded knowledge networks” (EKNs) to describe the basis for the authority which credit rating agencies possess. Depending on circumstances, a variety of organisations act as EKN’s; professional associations, research departments, even trade journals. They “possess authority because of their publicly acknowledged track records for solving problems, often acting as disinterested ‘technical’ parties in high-value high-risk transactions, or in validating sets of norms and practices for a variety of service-provision activities.”³⁹

Sinclair suggests that as EKNs, credit rating agencies exercise authority over a transaction in two senses. First, they contribute to *control* in the financial system by constraining thinking to a range of possibilities and, as a consequence, shape the behaviour of market actors. Second they also *rule* in that they exercise a veto over certain options leading to changes in thinking and behaviour within markets.⁴⁰

In relation to their role in the funding of the public sector they are influencing the shape and ownership of public infrastructure and the priorities of government. As their role has expanded they have become a form of private authority performing a quasi-public role of regulation.

Central to the impact they have on government and the public sector in Australia is the overwhelmingly orthodox ideology they bring to their task which goes to the heart of the distinction between public and private goods. It is characterised by a belief in the need to reduce welfare expenditure in favour of income generating activity, to increase the influence of the private sector and, as far as possible, have services provided through the market or ensure full cost recovery of those provided through the public sector.

³⁷ South Australian Financing Authority, "Third Annual Report 1 July 1984 to 30 June 1985," (Adelaide: 1985).p.21

³⁸ Seabrooke, "The Political Economy of Direct Financing". p.44

³⁹ Sinclair, "Reinventing Authority." p.488 see also Virginnia Haufler, "Private Sector International Regimes," in *Non-State Actors and Authority in the Global System*, ed. Richard A. Higgott, Geoffrey R. D. Underhill and Andreas Bieler, *Routledge/Warwick Studies in Globalisation* (London: Routledge, 2000). p.122

⁴⁰ Sinclair, "Reinventing Authority." p.489 also Sinclair, "The Infrastructure of Global Governance." p.443

Reducing debt, particularly through privatisation is also central to the agencies views of what goes toward creating a strong balance sheet. ⁴¹

GLOBAL CHANGE AND AUSTRALIA'S FINANCIAL SYSTEM

The structure of the Australian economy in the 1980s, with its heavily traded currency, current account problems and exposure to debt, combined with relatively small size, resulted in a high degree of vulnerability to international market sentiment.⁴² The structure of the economy made Australia something of a "leading indicator" of changes likely to occur from the pressures associated with globalisation.⁴³

Changes in the Australian financial system were among the most important of the structural changes which "globalised Australia", particularly floating of the exchange rate in 1983 and financial deregulation in 1984.⁴⁴

The sweeping changes that occurred by way of reductions or removals of controls over the Australian financial system during the 1980s changed it from one of the most controlled banking systems in the world to one of the least controlled.⁴⁵

The process started in the 1970s with the gradual removal of controls over bank interest rates but picked up speed in the 1980s following major reviews by high-level committees of enquiry. Reforms included the freeing up of interest rates on government securities and a new system of tender rates for new issues, and opening up the banking system to foreign competition.

These changes led to the rapid growth in the size and sophistication of financial markets, a significant increase in the size of the financial sector relative to the overall economy and most significantly, "the shift away from traditional intermediation through balance sheets of financial institutions towards intermediation through markets".⁴⁶ The net effect was "a

⁴¹ Sinclair, "Between State and Market." pp 459-460 In this regard it is somewhat ironic, given Labor policy on the sale of public assets, that the reports on South Australian finances by the credit rating agencies make it clear that state Treasurer Kevin Foley is only in sight of regaining the state's triple A rating because of the privatisation of the state's electricity assets and the consequent reduction in debt levels

⁴² Stephen Bell, "Globalisation, Neoliberalism, and the Transformation of the Australian State.," *Australian Journal of Political Science* 32, no. 3 (1997). p358

⁴³ Schwartz, "Small States in Big Trouble."p530

⁴⁴ D Meredith, and B Dyster, *Australia and the Global Economy: Continuity and Change* (Cambridge: Cambridge University Press, 1999). p. 322. They also include the ongoing reduction of tariffs among the main structural changes.

⁴⁵ J. O. N Perkins, *The Deregulation of the Australian Financial System: The Experience of the 1980s* (Melbourne: Melbourne University Press, 1989). p.1

⁴⁶ Marianne Gizycki, and Philip Lowe, "The Australian Financial System in the 1990s," in *The Australian Economy in the 1990s: Proceedings of a Conference Held at the H.C. Coombs Centre for Financial Studies, Kirribilli on 24-25 July 2000*, ed. David Gruen, and Sona Shrestha (Sydney: Reserve Bank of Australia, 2000). p180

transformation of the Australian financial system from a relatively closed, oligopolistic structure in the 1950s and 1960s based predominately on traditional bank intermediation, to a more open and competitive system offering a much wider variety of services from an array of different providers"⁴⁷

The growth in direct financing through financial markets continued in the 1990s. However, this did permanently reduce the overall importance of the banks in the Australian financial system, who diversified the services they offered and transformed themselves from narrowly based intermediaries to broad financial services providers.⁴⁸

The changes in the financial system also led to a rapid growth in risk mediation and securitisation products. Gizycki and Lowe point to the emergence of a market for asset backed securities as the "clearest example" of the greater role played by markets in financial mediation, with the first securitisation programs being developed by state governments in the mid 1980s to finance loans to low income households.⁴⁹

As the financial markets expanded and deepened, state governments were willing and active participants in an environment in which the influence of credit rating agencies could only grow stronger.

But, traditionally the right of the states to borrow had been controlled through the Loan Council. The story of the entry by the states into the financial markets to create this new environment is also the story of fundamental change in the way in which the Loan Council operated, changes which mirror the disintermediation that occurred throughout the financial system.

THE STATES GET RATED: "DISINTERMEDIATION" WITHIN THE LOAN COUNCIL

Government borrowing occupies a special place in the history of the Australian Federation, particularly given its connection with the issue of revenue distribution between the states.⁵⁰ Similarly, changes to the arrangements by which the level of borrowings were determined, and the means by which those borrowings were made, occupies an equally special

⁴⁷ Malcolm Edey, and Brian Gray, "The Evolving Structure of the Australian Financial System," in *The Future of the Financial System: Proceedings of a Conference Held at the H.C.Coombs Centre for Financial Studies, Kirribilli on 8-9 July 1996*, ed. Malcolm Edey (Sydney: Reserve Bank of Australia, 1996).

⁴⁸ R Battellino, "Australian Financial Markets: Looking Back and Looking Ahead," *Reserve Bank of Australia Bulletin* (2000). p.19

⁴⁹ Gizycki, "The Australian Financial System in the 1990s." p.199

⁵⁰ Cheryl Saunders, "Government Borrowing in Australia," *Melbourne University Law Review* 17 (1989). p.187

place in the story of the Federation's exposure to the global economy, and the growing influence of "the markets" over government and the public sector.

These "arrangements" are encompassed within the Financial Agreement Act and the procedures of the Australian Loan Council. The changes which took place from the late 1970s to 1993 in the control by the Council of the borrowings by state governments, and subsequently the formal amendment of the Act, set the conditions for the critical role that credit rating agencies play in the public sector today.

Up to the end of the 1970s the controls on borrowings by the States through the Loan Council mirrored the strict regulation that characterised the financial system in that period. The borrowing powers of the states were tightly controlled and the Commonwealth conducted all borrowings on behalf of the states. The Commonwealth was responsible for the national debt, with both levels of government contributing to a National Debt Sinking Fund. The Commonwealth in turn provided grants to the States to help them make interest payments on the debt raised on their behalf, and their contributions to reducing that debt through the Sinking Fund.

By 1993 the States were responsible for managing their own debt. The requirement for Commonwealth and State borrowing to be approved by the Council had been removed, as was the Commonwealth's explicit power to borrow on behalf of the states, and the restriction on State's borrowing through the issue of securities in their own name. The borrowing arrangements of the Federation had become as "unregulated" as the financial system with the States active players in domestic and global financial markets.

The changes that took place represent a process of disintermediation and direct financing similar to that which characterised deregulation in financial markets. Under the previous arrangements the Commonwealth acted as a financial intermediary between the States and the market. The States took advantage of the Commonwealth's credit status leaving the Commonwealth to mediate all of the risk. The changes saw the Commonwealth stand aside from its role as an intermediary, fully exposing the States to risk, and hence the need to establish and maintain their own credit rating which, as fiscal federalism engaged with the new global finance, would be monitored by the credit rating agencies.

The driving force for the changes in Loan Council arrangements was primarily the determination of the Commonwealth to cut back spending by the States. The Council had increasingly been used by the Commonwealth as an instrument of macro economic policy and, given the voting arrangements which gave the Commonwealth two deliberative votes as well as a casting vote; it was an instrument that the Commonwealth could control.

In the 1980s the floating of the Australian dollar exposed the currency to market sentiment regarding the level of overall public sector debt in Australia given that the Commonwealth was ultimately responsible for that debt under the Financial Agreement. In the 1980s the need to reduce the Public Sector Borrowing Requirement (PSBR) encompassing the borrowings of the Commonwealth, the State's and the Territories, added a new urgency to traditional round of spending reductions. For the Commonwealth the "audience" waiting for the result of Loan Council deliberations was as much "the markets" as it was the domestic political constituency.⁵¹

But when the Commonwealth found that the States were increasing bypassing the formal controls imposed by the Loan Council, thus reducing its value to them as a policy instrument, they turned to the markets for a solution.

CHANGE IN THE LOAN COUNCIL: MOVING TO THE MARKET

It is ironic that the framework for government borrowing which now applies between the Commonwealth and the States has returned to arrangements which are much closer to those that applied at the time of federation a century ago, and which were found wanting soon after the states came together.

Despite considerable debate prior to Federation on the importance of borrowing powers, the Constitution that came into force in 1901 gave the Commonwealth power to take over the pre-federation debts of the states but was silent on the issue of controls on future borrowings.⁵²

By 1919 both the states and the new Commonwealth government were borrowing heavily. On the Commonwealth's part there was a need to redeem or convert war debt, while the states needed to fund development, particularly railways. The competition between them was both intense and economically damaging and created pressures that led to the formation of a voluntary Loan Council in 1923.

This was followed by The Financial Agreement ratified by all Australian Parliaments in 1927-28 and a successful referendum in 1928 which allowed the Commonwealth to "make agreements with the States with respect to the public debt of the states". Armed with these new powers, the Commonwealth validated the Financial Agreement and established the Loan Council.

⁵¹ As a participant at Loan Council meetings through the 1890s I often watched as groups of Treasury officials anxiously discussed, and waited for, the reaction of "the market" to the deal they had invariably imposed on the State's.

⁵² The constitutional issues debated in the Conventions leading up to Federation are discussed in Saunders, "Government Borrowing in Australia." p187-189

While the Financial Agreement covered borrowing by the States it did not include borrowings by semi-government or local government authorities. From the outset attempts were made to restrain the borrowings of authorities, and to control the overall terms and timing of borrowings by requiring consultation with the Chairman of the Loan Council. However, this proved unsatisfactory and the consultation arrangements were formalised into what became known as the "Gentleman's Agreement". As the name implies, the agreement had no legal force, however, in later years the Commonwealth enforced the Agreement by making compliance a condition of underwriting arrangements.⁵³

These arrangements operated relatively unchanged until the 1970s when the borrowing arrangements within the Loan Council were completely recast in response to global financial deregulation and the growing sophistication of financial markets. This had led to a rapid growth during the 1960s and 1970s in the number of "authorities" seeking to enter the markets.

The first response was to devolve responsibility for compliance with Loan Council parameters for the terms and conditions of these loans to the individual states. However, towards the end of the 1970s, " the Loan Council began to re-examine and amend these controls to allow markets to cope with the increasingly large public sector borrowings and increasing sensitivity to yields offered on government securities. The markets themselves had also become a good deal more sophisticated, with wider and deeper secondary markets beginning to emerge, as were complex arrangements for coping with risk, including interest rate futures markets and expanded short term markets (e.g. bank bills and promissory notes). New financial institutions had also emerged, offering business and Government an increasingly wide range of services in a more competitive environment."⁵⁴

In 1978 the Loan Council approved new guidelines for special additions to the borrowings of larger authorities for financing infrastructure, ostensibly in response to the resources boom. These changes also allowed for these borrowings to be undertaken overseas.⁵⁵

In 1980 the Council adopted new arrangements which moved further in the direction of a market-orientated approach to borrowings by semi-government authorities. In 1982 all controls over the amount and terms of issue of domestic borrowings by electricity authorities were removed. At its meeting

⁵³ Saunders. p.203-204

⁵⁴ "Budget Paper No.7 Payments to or for the States, the Northern Territory and Local Government Authorities 1983-84. Parliamentary Paper 99 of 1983," (Canberra: AGPS, 1983).p.31

⁵⁵ "Budget Paper No.7 Payments to or for the States, the Northern Territory and Local Government Authorities 1978-79. Parliamentary Paper 208 of 1978," (Canberra: AGPS, 1978).p.32-33

in June-July 1983, the Council "effectively completed a process of deregulation of semi-government authorities' domestic borrowings" with its decision to remove all controls over the terms and conditions of borrowings by authorities.⁵⁶

By the mid 1980s it became clear that these arrangements were not able to restrain borrowings by state authorities and the central borrowing authorities which each of the States had established. In large part this was the result of state authorities resorting to what the Loan Council reports described as "non-conventional" financing arrangements particularly involving the sale and leaseback of public assets. By this time the Commonwealth was increasingly concerned with the total size of the PSBR and in particular that part of it which related to borrowings by the states. It was clear that the Loan Council's rules were having little effect particularly as much of the increase was financed outside programs approved by the Loan Council.⁵⁷

Consequently, in June the 1984 the "Gentleman's Agreement" was temporarily suspended and then in 1985 the Loan Council formally terminated. It was replaced by the concept of "Global Limits" by which the Commonwealth and the States agreed to voluntarily limit the level of all new borrowings from all sources by their authorities, government owned enterprises and trusts.⁵⁸

This change was reinforced by in 1990 the decision that the States and Territories would progressively take over responsibility for their own debt. In a further move towards deregulation the Council also agreed to amend the Financial Agreement to allow the states the right to issue securities in their own name.

The decision to give the States' full responsibility for managing their own debt was aimed at increasing the ability of the markets to "regulate" their borrowings as it was expected to "... direct growing attention to the fiscal and debt management strategies of individual states"⁵⁹

By 1993 further changes had been made completing the process of deregulation which had begun in the 1970s. The changes recognised that the "global limits" approach had broken down in the face of the increased use of sophisticated financing techniques used by the states that had allowed the

⁵⁶ "Budget Paper No.7 1983."p.33

⁵⁷ "Budget Paper No 1, Budget Statements: Budget and Other Public Sector Transactions since 1974-75 (Statement No 6)," (Canberra: AGPS, 1984).pp.376-378

⁵⁸ "Budget Paper No.7 Payments to or for the States, the Northern Territory and Local Government Authorities 1986-87. Parliamentary Paper 184 of 1986," (Canberra: AGPS, 1986).p.39

⁵⁹ "Budget Paper No.4 Commonwealth Financial Relations with Other Levels of Government 1990-1991," (Canberra: AGPS, 1990).p.64-66

Loan Council and its rules to be circumvented.⁶⁰ As a result the global limit approach was replaced by the concept of a Loan Council Allocation (LCA). The LCAs were based on a measure of the deficit or surplus of each state as a measure of the financing requirement rather than their gross borrowings. Their aim was to capture transactions which had the effects of borrowings but were not formally classified as such.

The move to LCAs was accompanied by the development of uniform and more comprehensive arrangements for the reporting of public sector finances intended to meet the markets need for accurate and meaningful information about the level of net borrowings on the part of each of the states. The intention was to "facilitate financial market scrutiny of public sector finances via better reporting and so make jurisdictions more accountable to the markets".⁶¹

The 1992 meeting of the Loan Council also agreed to amend the Financial Agreement to permit the states to issue securities in their own name in both domestic and overseas markets and to remove the requirement that borrowings needed to be approved under the provisions of that agreement.

Taken together, these changes completed the process which had been underway for more than a decade, of moving the control of government borrowing back into the market, and this establishing a new relationship between the public sector and the markets. As the Commonwealth budget papers described the process: "The changes in Loan Council arrangements broadly reflect the evolving nature of financial markets and their interaction with the public sector. The new arrangements are designed to enhance the role of financial market scrutiny as a discipline on the public sector and, in doing so, build on the changes instituted in the 1980s to enable the individual states to assume responsibility for managing their own borrowings and to be accountable to financial markets for their actions"⁶²

IMPLICATIONS

Understanding the evolution of the role that credit rating agencies now play in financing the public sector helps explain how and why globalisation has changed politics and the development of public policy within the Australian states. Their role has evolved and strengthened as direct engagement with global financial markets became a major part of the process of financing the public sector in Australia. As a result credit rating agencies have come to occupy a central position in that process from which they have not only

⁶⁰ "Budget Paper No.4 Commonwealth Financial Relations with Other Levels of Government 1992-1993," (Canberra: AGPS, 1992).p.65

⁶¹ Budget Paper No 4 1992.p.67

⁶² "Budget Paper No4: Commonwealth Financial Relations with Other Levels of Government 1993-1994 Pp90 of 1993."p.65

moved the public sector towards an embrace of the agenda of the markets, but have also kept them there. As private authorities performing a quasi-regulatory function they have contributed to the growing dominance of the market as a means of determining the nature and the means of distributing public goods.

The practical consequences of that dominance are seen at a number of levels. Most obvious has been the priority given in budgets to reducing debt and borrowing requirements by a combination of assets sales and reduced expenditure. The corollary of reduced debt has been surpluses, recorded on a transparent accrual basis, and a commercial rate of return on public assets.

In terms of organization and structure, formal market competition principles expressed through National Competition Policy have reshaped public sector enterprises and, along with the need to reduce debt, has provided a rationale for corporatisation, privatisation and public private partnerships.

It has also has changed the relationship between the public and private sector and to an extent blurred the distinction between them. It has encouraged the acceptance of private sector models of management to organize traditional public sector tasks, and by moving to employment-based contracts, it has significantly changed the ethos of the public sector. It has also accelerated the movement of traditional public sector functions and positions directly to the private sector through outsourcing and the contracting.

All of these changes within the public sector represent important areas for study and are of significant relevance for teaching in the area of public policy and management. They are also matters which are not peculiar to Australia having significance for the public sector in any economy which is engages with global markets to seek capital for growth and development.

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