Submission to Murray Review into the Australian Financial System. (**http://fsi.gov.au/**)
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Key issues raised in submission.

- *The Wallis Inquiry based its recommendations for regulating the Australian Financial system on the assumption of the validity of Efficient Market Theory, which has now been discredited. This goes to the core of financial system regulation in Australia and so must be reviewed and a new theoretical basis needs to determined.*
    - Related issue: Central Banks (and Treasuries) have typically relied heavily on classical economic thinking. This theoretical framework failed in the 2008 Financial Crisis.
    - Some possible sources of ideas for a new theoretical basis for regulation and management of Australia's financial system:-
        - George Soros' The Institute for New Economic Thinking (Inet).
        - Austrian School of Economics – which enabled followers to foresee the 2008 Global Financial Crisis.
- *Australia has all the same key preconditions as the US had before its 2008 crisis* that created a devastating economic damage and near collapse of the US banking system. The two critical ingredients were the historically large house price bubble and historically large personal debt bubble.
    - Australia is not sufficiently prepared to deal with such a crisis.
        - Our banking system is unlikely to cope any better than USA's banking system in the face of a historic house crash.
        - The Australian taxpayer is likely to end up underwriting the Australian banking system – though Bank of International Settlements (BIS) points to better solutions than were implemented by the US & Europe in the 2008 crisis.
        - Australia has large "too-big-to-fail" institutions that are allowed to take too much risk and who do not pay for the implicit tax-payer guarantee.
    - Australia needs to implement the Volcker Rule, to help better prepare for a future financial crisis.
    - Australia needs to follow current BIS thinking that in the event of a bank failure, the shareholders and creditors (eg bond holders, holders of bank hybrid securities) need to bear the bulk of the losses – and further measures are required to minimise the potential cost to Australian tax payers. We need to learn from the experience so far in USA and Europe, even though (so far, in those geographies) powerful banking system lobbyists have made it difficult for deliver adequate financial system reform.
- The biggest emergence in history (emergence of 3 billion people in the BRICs http://en.wikipedia.org/wiki/BRIC and the Next-11 http://en.wikipedia.org/wiki/Next_Eleven) is likely to have profound ramification for Australia – and we are not adequately dealing with this.
    - It is likely to to reduce Australia level of real wages over the next 3 or 4 decades, with effects to be felt from now. The choice will be higher unemployment or lower wages. Reference price convergence in emergence events – Russell Napier – 2003.
        - This is likely to have major negative effect on the Federal government tax base (and also social security expenses.)
    - Outsourcing to the emerging world is already making it very difficult for both skilled and unskilled young people trying to enter the work force. The risk is that we develop a long-term youth unemployment problem, sowing the seeds for major structural problems in the tax system over time – as Australia ages.
    - While this issue may not be a focus of the Financial System Inquiry, this issue needs to be contemplated when planning all aspects of Australia's future.

Some background on key issues:

- The Wallis Inquiry presumed the validity of efficient market theory, as a basis for the Australian regulatory framework. Now that efficient market theory has been discredited, it is important that a new theoretical basis be determined, on which to build an updated regulatory basis for the Australian Financial System.
  - From http://www.puzzlefinancialadvice.com.au/govtsubmissions.htm
    - 30/7/2009 Puzzle Financial Advice seventh supplementary submission (http://www.puzzlefinancialadvice.com.au/Puzzle%20Financial%20Advice%20supplementary%20submission%207%20090730%2023.pdf) to Parliamentary Joint Committee Inquiry into Financial Services. ASIC says it believes that "markets operate most efficiently when there is a minimum of regulatory intervention. So, in short-hand form, this might be termed the efficient market theory." Why is this a potential problem for Australia's future?
      - Attachments:
        - AFR 25th July 2009 "Old economics under fire." Central banks using flawed models. Likewise regulators. http://www.puzzlefinancialadvice.com.au/090725%20AFR%20central%20banks%20using%20flawed%20models.pdf
        - 8/8/2009 AFR ASIC chairman Tony D'Alosio defends ASIC's use of efficient market theory. He also acknowledges some of the weaknesses in efficient market theory. He then throws the responsibility of shifting the philosophy behind regulating financial services in Australia over to the Australian government. This is a cop-out on a very important issue. http://www.puzzlefinancialadvice.com.au/090808%20AFR%20ASIC%20Dalosio%20on%20efficientmarkets.pdf
        - 13/Aug/2009 Dr Steven Kennedy, General Manager, Competition and Consumer Policy Division, Australian Treasury also discusses the weaknesses in efficient market theory. Steven Kennedy also explains that Treasury's thinking is shifting away from efficient market theory. http://www.puzzlefinancialadvice.com.au/090813%20treaury%20is%20moving%20away%20from%20efficient%20market%20theory.pdf
- Central banks have relied heavily on classical economics in recent decades. However, this theoretical framework has been seen by many to have failed in not foreseeing the 2008 Global Financial Crisis.
  - After the global financial crisis, George Soros founded The Institute for New Economic Thinking (Inet), to search for a new set of economic theories. http://ineteconomics.org/george-soros-why-we-need-rethink-economics-0 This link on the Inet web site contains a video interview of George Soros as he explains why we need new theory.
    - Quote from http://ineteconomics.org/about
      - "The havoc wrought by our recent global financial crisis has vividly demonstrated the deficiencies in our outdated current economic theories, and shown the need for new economic thinking – right now."
  - A number of followers of the Austrian School of Economics (http://en.wikipedia.org/wiki/Austrian_School ,http://wiki.mises.org/wiki/Austrian_School) foresaw the 2008 global financial crisis. (http://wiki.mises.org/wiki/Austrian_predictions).
    - The US house price bubble, was a key precursory to the GFC. Some Austrian school economists predicted the crash in US house prices, and its catastrophic implications

for the US banking system.

- http://wiki.mises.org/wiki/Austrian_predictions/Housing_bubble
- http://wiki.mises.org/wiki/Austrian_predictions#Housing_bubble
  - For example, "In **2004**, Mark Thornton wrote that higher interest rates (indicated by the Fed) "should trigger a reversal in the housing market and expose the fallacies of the new paradigm, including how the housing boom has helped cover up increases in price inflation. Unfortunately, ***this exposure will hurt homeowners and the larger problem could hit the American taxpayer, who could be forced to bailout the banks and government-sponsored mortgage guarantors who have encouraged irresponsible lending practices***."[15] Later on, he spelled out the consequences for the construction industry, unemployment, foreclosures, bankruptcies, ***bailouts of banks*** and GSEs, and a long recession.[16] "

- One of the key features of Austrian School economics, is their understanding of the role, importance and risks of debt. This is important at this time, because many developed world countries now have their biggest debt bubbles (including Australia) in their financial history.
- Hopefully, Australia can learn from the US house price crash experience and GFC, to better prepare Australian banking regulations and Australian banks for our own 2008-style of financial crisis, brought on by our own house price crash. Australia has the biggest house price bubble in its history, a bubble that has been funded by Australia's historically-largest private debt bubble (which is predominantly mortgage debt).
  - http://www.philipsoos.com/housing-prices/
  - http://www.philipsoos.com/private-debt/
    - Note: Perhaps the most well-known person to call the US house price bubble before it burst, was Professor Robert Shiller. Robert Shiller published his analysis of US house prices in second edition of "Irrational Exuberance" published in 2005, which is before the US house price bubble started bursting in mid 2006.
      - http://www.econ.yale.edu/~shiller/data.htm
      - http://www.econ.yale.edu/~shiller/data/Fig2-1.xls
    - The warning for Australia, is that if Robert Shiller's analysis was applied to Australia's data, you would have to conclude that Australia has the biggest house price bubble in its history. (The data suggests that it is quite likely that the coming Australian house price crash will be bigger than what APRA has prepared for – i.e. bigger than 30% fall.) From an economic perspective, this should be cause for great concern as this is a major risk to the Australian economy and Australia's financial system.
- Given that the data strongly suggests that Australia will have in the near-future, a financial crisis similar in style and cause to the 2008 financial crisis in the USA, Australia should adopt measures recommended by past chairman of the US Fed, Paul Volcker. (http://en.wikipedia.org/wiki/Volcker_Rule)These measures include:-
  - **The commercial banks.** The government to provide an explicit guarantee to Australian commercial banks – the core of the system. These commercial banks would simply focus on deposit taking and providing credit. These commercial banks must be more highly regulated. These commercial banks would need to divest all highly risky entrepreneurial activities including proprietary trading and wealth management. In this vital sector, it is not acceptable that shareholders and executives gamble to win gains from risky activity, where taxpayers may wear the big losses.

        - **The capital market system**. Capital market players are dealing with each other. They're trading. They're about hedge funds and equity funds. They don't need to be so highly regulated. They're not at the core of the system, unless they get really big. (eg Too big to fail.) If they get really big then you have to regulate tightly them, too. Otherwise, these have to be allowed to fail (i.e. no bailouts.)
        - Since some Australian insurance companies are **"too big to fail"**, they would have to be regulated more tightly as well. If financial institutions become "too big to fail", shareholders and executives benefit from the gains from risk-tasking, but taxpayers potentially wear the losses as we have seen with AIG's failure/rescue during the 2008 GFC. Surely this is no longer acceptable.
    - **Recommendations**:
        - *The theoretical economic framework used by the RBA and the Australian Treasury needs formal review – a search for replacement of classical economic theory is required.*
        - *A new theoretical basis for Australian Financial System regulation is required – to replace efficient market theory used by the Wallis Inquiry, and which underpins Corporations Law.*
        - *The Volcker Rule needs to be implemented in Australia.*
        - *Australia needs to prepare for possibly the biggest house price crash in its history – including financial system regulation changes as discussed above*.
- Implications to Australian Financial System of the biggest emergence event in history (and also the Aging of the Australians).
    - Approximately 3billion people in the emerging world (including China, India, etc) are emerging from comparative poverty into the middle class. This event will continue for the next 3 or 4 decades or so.
    - A central impact of emergence events like this is price convergence (Russell Napier study 2003). A key price to converge is wages, probably implying that over the next 3 or 4 decades, it seems likely that standards of living will fall in real terms in much of the developed world – because of wage price convergence between the developing and the developed world.
    - In the emerging world, there is a large (and growing) highly educated, English-speaking workforce who are already competing with Australians for knowledge work. The emerging world also contains large quantities of cheap labour, that are competing for Australian jobs in manufacturing and unskilled work.
        - The work force in the emerging world, competing for Australian jobs, is prepared to work for a fraction of current Australian wage levels.
        - This is causing:-
            - the manufacturing sector in Australia to shrink.
            - Outsourcing of many jobs to the emerging world. We have seen this for years already in big business such as the big banks, for call centres, among the big 4 accounting firms, SMSF administration etc etc. Outsourcing is increasingly taking hold among small business through companies such as http://www.freelancer.com.au/ . This is now pervasive throughout Australian business.
            - In turn, this is making is much more difficult for young people to find work (particularly for their first job). This is happening for both unskilled and skilled (eg university educated) young people. As the average age of Australians rise, if our young people cannot find work, the tax base will be eroded for Australia's future. This is potentially a huge problem for Australia's future.
            - This seems to be causing a long-term structural unemployment problem in Australia.

    - Sadly, I think we will shortly have to choose between higher unemployment and lower wages.
  - But maybe there are some ways that this phenomena can be used to out benefit. For example:
    - If we look at the Federal Budget, health care costs are rising very rapidly. Perhaps outsourcing might help keep health care costs manageable.
    - Other major budget line items need to be reviewed in this context.

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