

**Financial System Inquiry
(private) submission by
Dr. Troy Lynch**

31 March, 2014

Dear Sir/Madam,

The following submission addresses a number of the terms of reference of the Financial System Inquiry.

Sincerely,

Troy Lynch PhD.

Funding economic growth

Australia has a very small and illiquid capital market. A significant portion of capital for economic growth is sourced from overseas capital markets (apart from that sourced from Australian domestic savings). It is imperative that the existing deregulation of capital controls be maintained. Impediments that preclude the lowest of cost approach for an Australian entity to raise capital on overseas markets, or for the purpose of accessing overseas markets with minimal legal or regulatory constraints (assuming that the risk for that action is borne by the shareholders of an Australian entity), should be removed.

Domestic competition

There needs to be more competition in the banking sector. The unfair advantage that benefits the big four banks must be addressed. They enjoy unfair cost-of-funding advantages. As a result, inadequate incentives exist for genuine competition for those institutions that do not share this advantage.

The big four banks benefit from an implicit Government guarantee. APRA noted that this can encourage excessive risk, the reduction of market discipline and therefore creates competitive distortions, which further increases the possibility of future distress. The dominance of the big four banks must be reduced and further competition promoted.

Thus smaller institutions have to compete on the market for capital by offer yields that are higher than the big four banks. This has distortive effects on the market and it is unfair to consumers.

The cost of risk – taxpayers

The cost of risk depends on knowing who bears that risk (e.g., customers, shareholders or taxpayers) and how they are rewarded. The existence of so-called ‘Too Big to Fail’ institutions reveals the possibility that taxpayers may not be adequately rewarded for the risks such institutions impose upon them. Indeed, one suggestion is to mitigate the risk by imposing guarantee charges and conditions on relevant institutions. However, this suggests, contrary to the previous section on increasing the nature of domestic competition in the Australian banking sector, that such risks borne by the taxpayer should be supported (e.g. via the use of government guarantees).

This implies that financial institutions should be supported by the taxpayer. However, this simply substitutes away the discipline of market or systemic risk and transfers it to the taxpayer. It is also a tacit vehicle for further government intervention, in which the view holds that taxpayer-sponsored risk mitigation of financial institutions is a first best and efficient policy, which is not the case. An entity that operates on the market and places the funds of shareholders at risk in order to achieve capital growth and income; the same shareholders should bare the risk of their action (and those of their representatives who operate the entity), and not the public or the taxpayer.

If argued otherwise it follows that, as per the events that followed the Global Financial Crisis (GFC) in Australia, government guarantees offered to banks should be offered to other

institutions and companies (though this is a tacit move to nationalisation and further intensive government intervention). If certain financial institutions are considered a special case, then it follows that the Australian financial sector is too dependent on the oligopolistic banking sector, that it possesses too much power vested in their operations, and therefore a greater level of competition should be encouraged in the banking sector. The so-called four pillar banking sector should be replaced by a more intensive competitive market in the banking sector, which places less reliance on a certain few institutions (in which each institution, big or small competes on as equal a footing as possible).

The cost of risk – clients

The *Banking Act 1959* (Cth) should not be changed or altered to remove the risk inherent in deposit-taking institutions (ADIs), such as banks, building societies and credit unions, currently borne by the shareholders or equity-owners of such institutions in the event of an ADI declaring itself unable to meet its obligations or that it is about to suspend payment or that it is under-capitalised or

likely that the ADI will be unable to carry on banking business in Australia consistently with the interests of its depositors; or ... it is likely that the ADI will be unable to carry on banking business in Australia consistently with the stability of the financial system'¹

Neither should the *Banking Act 1959* (Cth) or other legislation be altered to provide legislative power to convert depositors of the deposit-taking ADI they currently deposit with into shareholders or equity-owners of such institutions in the event of an ADI declaring itself unable to meet its obligations or that it is about to suspend payment or that it is under-capitalised or '(iii) likely that the ADI will be unable to carry on banking business in Australia consistently with the interests of its depositors; or (iv) it is likely that the ADI will be unable to carry on banking business in Australia consistently with the stability of the financial system.'²

This risk is one that should be borne by the shareholders, not customers or taxpayers. The recent experience in Cyprus is evidence of depositors' funds being withheld and converted into equity (the so-called 'bail-in' of customers). The following FDIC-BOE document, '[Resolving Globally Active, Systemically Important, Financial Institutions](#),' discusses, in the light of the GFC, that another method, other than taxpayer bailouts, was required. The document states that

An efficient path for returning the sound operations of the [globally active, systemically important, financial institutions] to the private sector would be provided by exchanging or converting a sufficient amount of the unsecured debt from the original creditors of the failed company [the depositors] into equity. ... the new equity holders would take on the corresponding risk of being shareholders in a financial institution.'

This is unacceptable and shifts the risk of the financial entity from shareholders to customers.

Superannuation funds

¹ *Banking Act 1959* (Cth) s 13A(1)(b)(iii-iv).

² Ibid.

The existing stock of superannuation funds – at present, approximately \$1.7 trillion – should not be available for government directed or targeted investment in the Australian economy. That is, neither the federal or state governments, nor any government agency, should possess or wield legislative power to direct the use of private superannuation monies. This should be left to the discretion of superannuation funds and their members.

Neither should such private superannuation monies be available to be used by federal or state governments to resolve funding problems by either federal or state governments or public or semi-public entities or agencies, or as a source of capital or capital support or investment by or for public or semi-public entities, such as a loan, grant or investment. Neither should federal or state governments, or any government agencies, possess legislative power or otherwise to direct such privately-owned superannuation monies for the purpose of capital support or investment of privately-owned entities as a loan, grant or investment.

Policy planning for this most important accumulation of funds (which is expected to double by 2028) should not be an area that is directly legislated by either federal or state governments. The reason is that, given that these funds are privately-owned monies, direct intervention by the state with the intention of directing such funds into specific investment areas will not be as efficient as those investment areas determined by a specific fund and its members.

Ownership of assets

The purpose of ‘Part IV – Gold’, sections 40 to 48 (inclusive), of the *Banking Act 1959*, is now redundant. It should be deleted. A liberal democracy and a competitive market economy should neither constrain the free flow of capital nor any asset deemed to be an equivalent means of economic exchange, such as gold (no matter what the concern over the protection of the currency).

The notion that gold, is to be vested in and delivered to the Reserve Bank (*Banking Act 1959* (Cth) s 42-3) in exchange for a payment to that person for that gold delivered to the Reserve Bank (s 41), presupposes that, upon the operation of this part, ‘Part IV -- Gold,’ of the *Banking Act 1959* (Cth s 40), the Reserve Bank of Australia, apart from exemptions, is to be the sole possessor of gold in the Commonwealth ‘for the protection of the currency or of the public credit of the Commonwealth’³ during the operation of this Part (section 40). This assumes that gold can be forcibly obtained by the Commonwealth.

Australia is a liberal democracy. The notion of the transfer and possession of property from one party to another party without that first party’s consent is the illegal removal of that property. It is theft. That gold can be forcibly removed from the possession of the first party through the vehicle of legislative power by the Commonwealth is no less unconscionable and no less the unwilling seizure, transfer and possession of that property by the Commonwealth from that party than by another party.

For example, notwithstanding the basic definition of theft as a ‘person [who] steals if he dishonestly appropriates property belonging to another with the intention of permanently

³ *Banking Act 1959* (Cth) s 40(2).

depriving the other of it,⁴ it is no less true even with the good intentions of other legislation designed to achieve a particular policy outcome. This is evident in the United States' *Gold Reserve Act of 1934*, which made illegal the private possession of gold and forced individuals to sell their private gold to the US Treasury; the preceding *Executive Order 6102* (1933) made it a criminal offence for US citizens to own or trade gold. The purported reason was the so-called hoarding of gold. The corollary of theft is that a 'person guilty of theft is guilty of an indictable offence.'⁵

The Reserve Bank of Australia - easing of monetary policy

Though the terms of reference of this enquiry will 'not make recommendations on the objectives and procedures of the Reserve Bank of Australia (RBA) in its conduct of monetary policy,' it behoves the inquiry to examine the conduct and implications of the Reserve Bank of Australia. It is unreasonable to assume that the conduct of the central bank does not affect the conduct of financial markets.

The *Reserve Bank Act 1959* provides the unelected institution of the Reserve Bank of Australia with a monopoly on the issue of Australian banknotes. This precludes other individuals or institutions issuing 'a bill or note for the payment of money payable to bearer on demand and intended for circulation.'⁶ It follows that the Board of the Reserve Bank of Australia has the capacity to do what the market is already successfully doing in many areas in the economy – establishing prices. The price in question is of course the overnight cash rate, which dictates the term structure of interest rates. The market rate of interest, across any term period, is a rate that is meant to balance savings and investment.

If the money on issue in the economy were not fiat but privately issued, and possibly a commodity currency, the interest rate (across the yield curve) would adjust to equalise savings and investment. The history of the Reserve Bank of Australia most likely indicates that on many occasions it has been successful with the setting of the market rate of interest; equally, the setting on many occasions has been incorrect. However, prior to his Governorship of the Reserve Bank, Ian MacFarlane stated that it would be 'foolish to claim that the setting (of monetary policy) was always right'⁷

As has been widely reported, one possible cause of the recent GFC is credit expansion (in the United States). The credit expansion theory of the business cycle seeks to explain that the real goods' structure of the economy is stimulated when interest rates have been artificially lowered below what the market would have set them. This reduces the cost of capital to interest-rate sensitive industries and stimulates demand by those industries for money capital and factors of production. According to marginal economics, the prices of the factors of production are bid up, employment of factors improves and various higher-order industries are stimulated into productive growth.

This is unsustainable, however, as credit expansion cannot continue unabated due to the increase in debt. Also, the savings of the public have not changed, only the time price of

⁴ *Crimes Act 1958* (Vic) s 72(1).

⁵ *Crimes Act 1958* (Vic) s 74(1).

⁶ *The Reserve Bank Act 1959* (Cth) s 44(1).

⁷ MacFarlane, Ian (1991), 'The Lessons for Monetary Policy,' *Conference on the Deregulation of Financial Intermediaries*, Reserve Bank, June 1991.

money on the market – interest rates – has changed. It should be impossible to expand credit beyond the limits of available savings (however, fractional reserve banking does allow the apparent availability of money to expand). When interest rates rise, investment in these industries stalls and factors of production, including workers, are laid off. Individuals purchase less and thus less goods and services are produced. The economy moves into a retrogressive phase.

Thus the legislative power of the RBA is not allowing the interest rate to function as it was intended – to adjust consumption and investment. The new investment in higher-order goods' industries competes with consumption in the market, and thus prices rise. The apparently new money creates price inflation. However, prices do not all increase at the same rate. Prices rise faster when the new money is being loaned out, such as for investment.

The Reserve Bank of Australia - risk

One focus of this inquiry is to 'refresh the philosophy, principles and objectives underpinning the development of a well-functioning financial system.' Specifically, 'how financial risk is allocated and systemic risk is managed.'

While financial deregulation facilitated the excessive growth in credit during the 1980s, the underlying cause was the pursuit of macroeconomic policies which sought to stimulate, but were too accommodative to inflation (the inflation of prices noted above).

Another important area of concern is that the setting of interest rates has unintended consequences. A lowering of the overnight cash rate below the rate that would establish equilibrium between savings and investment can produce effects that distort the flow of funds and asset prices. Recent evidence indicates that compared to twenty years ago, the flow of funds directed to investment in residential property now outweighs that directed at investment in productive enterprises.

The opportunity cost decision made by investors in an environment of historically low interest rates re-directs capital into asset classes such as property and equities and out of the safer environment of cash and cash equivalent-based assets. It is the result of low interest rates, credit expansion and it encourages private debt. Australia currently has a very high per capita debt-to-income ratio. The disappointing thing is that while a portion of this is legitimate property investment, distortions of the interest rates to excessively low levels encourage speculation. Asset prices rise and the result is what Australia is left with now, in which the average price of a residential property has increased from two- to three-times the average income to between five- and seven-times the average income. It thus precludes housing affordability and encourages debt-based activity.