

Submission to the Financial Services Inquiry Feb 2014

Underlying Principals

This submission starts with the premise that Australia is an economy with a fiat currency and a floating exchange rate. The Commonwealth government is the primary public sector entity with the power to impose taxation upon private sector entities and is responsible for providing financing to state and local governments. The primary purpose of the Commonwealth government is to support the private sector, not to compete with the private sector.

Funding the Economy

There are two widely held but incorrect views regarding the way in which the Australian Economy is “funded”:-

- The Commonwealth government is required to borrow from the private sector in order to fund its spending; and
- Australian banks (Authorised Deposit Institutions or “ADI’s”) must first borrow funds in order to lend to customers

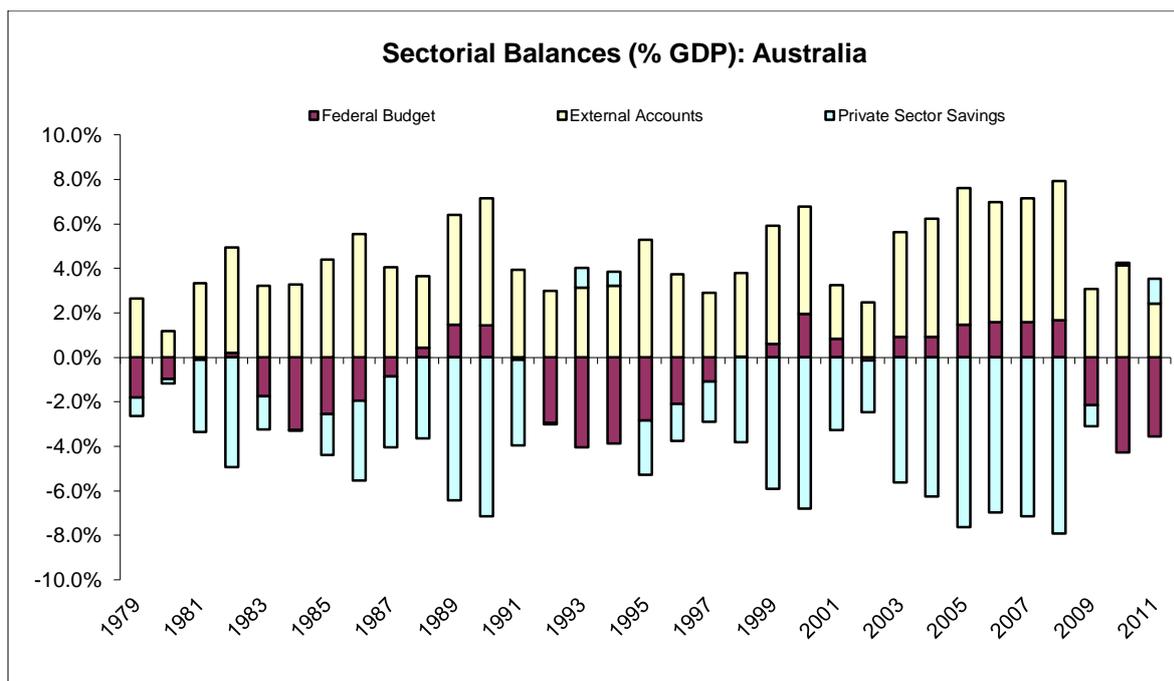
These mis-perceptions appear to derive from the assumption by non-financial private sector entities that the fiscal constraints that apply to the private sector also apply to ADI’s and the government. In fact, this is not the case, and these mis-perceptions lead to a misunderstanding of the constraints that apply to the way investment takes place and the way other aspects of the Australian economy function.

In this submission, we simplify the primary Australian institutions to the Commonwealth government itself and the Australian central bank (the Reserve Bank of Australia, or the RBA). Any reference to the Commonwealth government includes the functions of the Treasury and a reference to the central bank includes the functions of the Australian Office of Financial Management (AOFM). This simplification does not have a material bearing on the concepts and analysis discussed and avoids an unnecessarily technical discussion.

Government Spending and Borrowing

Unlike a private sector entity, Commonwealth government spending is not constrained by a need to borrow a-priori. All spending by the government takes place by directive. In simple terms, when the government spends, it does so by debiting the government’s own reserve account with the central bank and crediting private sector deposit accounts. Taxation by the government is not required in order for it to direct spending. Without a self-imposed debt ceiling, the size of the government’s reserve account is unlimited and the government may direct spending on any and all projects it considers worthy without imposing taxation of any kind. The effect of taxation is to reduce private sector demand, thereby creating unemployment which allows the government to acquire real resources from the economy in a non-inflationary way. Net government *is* constrained, in particular by the availability of real resources (raw materials, labour, food, energy etc) – this is discussed in more detail below. But a lack of funds to implement its spending can never be a constraint for a government of an economy with a fiat currency.

Net spending by the government results in an increase to the government’s aggregate deficit and an increase to the private sector’s equity (or a reduction in its leverage), since net government spending has no associated liability for the private sector. A government debt is a private sector asset. The sectoral balances are well understood (see below chart).



The Role of the Central Bank

One part of the RBA's mandate is to set the cash rate to meet an agreed medium term inflation target. When government directed spending exceeds taxation (a government budget deficit), the money supply available to the private sector is increased, and this is reflected in increased bank reserves with the central bank. In order to maintain its target cash rate, the RBA must offer interest bearing assets in the form of Commonwealth Government Securities (CGS) to the private sector to offset this increase in the money supply by reducing reserves and so avoid downward pressure on interest rates. The reduction of reserves via CGS results in the same reserves being credited back to the government (Treasury). There is no constraint in the size of the government's reserve account unless one is self-imposed in the form of a "debt ceiling" as was introduced by the Rudd government in 2008 and as a consequence of our monetary system, the government's reserve account will always be replaced with equivalent CGS.

The issuance of CGS is therefore not undertaken, as is commonly perceived, in order to provide funds to the government to allow it to spend - CGS issuance is first and foremost a tool of monetary policy. Since net government spending is the source of increased bank reserves, the demand for CGS will always equal the size of the government deficit and the central bank will never be unable to issue the required amount of CGS, because aggregate demand for CGS from the private sector is created by and equals net government spending (its reserve account). There may from time to time be greater or lesser demand for different duration of CGS at different yields, depending on investor views of future interest rates, meaning that demand for, and yields on, CGS with different terms (maturities) will fluctuate. One role of the AOFM is to manage the demand / supply balance across the yield curve. But demand for CGS will never be lower in aggregate than the government's deficit because the government's deficit itself creates the demand.

Constraints to Government Spending

When the government spends it utilises (buys) real resources available to economy (labour, materials, technology etc). By spending, the government provides an additional source of demand to the private sector which is a source of economic stimulus. If the economy has excess real resources available (eg unemployed labour or low capacity utilisation) then the additional demand will be met by a reduction in that available capacity. However, if the economy is functioning at capacity, meaning there are insufficient real resources available to supply the government's requirements, then government spending takes away resources that would otherwise have been available to the private sector. If government spending does not lead to offsetting increased production, Government demand places upwards pressure on prices.

To avoid this inflationary effect, the government must reduce the level of aggregate demand from the private sector, which is the primary purpose of taxation. Taxation is not required to provide funding to the government to allow it to spend, rather it is a tool to control the level of aggregate demand from the private sector for real resources in order to achieve price stability.

Governments should aim for a surplus (or reduced deficits) when the economy reaches capacity, and inflationary pressures are beginning to emerge.

In summary, the aggregate size of the government's deficit is not a constraint on its spending. The government can always choose to meet its debt servicing cost and re-financing obligations since it directs the central bank and the currency is fiat to the extent Commonwealth debt is denominated in Australian dollars. This is because Australia can never run out of Australian dollars. Australia does not source Australian dollar funding from foreign entities.

Bank Borrowing

In the same way that the issuance of CGS is a response to net government spending, rather than a pre-requisite, an ADI seeks reserves only after it has lent funds. When an ADI chooses to lend to a customer, it initially creates an asset (loan) and a liability (often in the form of a deposit) on its balance sheet. The loan is immediately funded via double entry bookkeeping. Following the creation of the asset and liability (but in practice usually on the same the same day), the following occurs:

- If the bank needs additional reserves to support its expanded balance sheet it will seek to acquire those reserves after the loan has been created
- When the newly created deposit is spent, the receiving bank will receive the deposits (liability) and reserves (asset) from this issuing bank.

The system is always in balance to the extent all assets and liabilities are in AUD, and no part of this process creates a need to borrow from foreign investors

If there are not enough reserves in the Banking system to support loan growth, they are supplied by the central bank via open market operations ("OMO"). The RBA will always supply these reserves since the RBA targets an interbank interest rate. If the demand for reserves exceeds the supply, the interbank rate will rise, and the RBA will lose control of monetary policy.

Creating the loan and associated deposit in the banking system adds to the money supply, initially in the form of a customer deposit with the bank but, once withdrawn, subsequently in the form of a deposit with another bank or potentially some other form. The increased money supply will lead to increased funds in the interbank market or add to the stock of banks' reserves with the central bank.

Constraints to Bank Lending

In the Australian banking system, the central bank targets interest rates, not reserve amounts, which means there is no central bank imposed constraint on the ability of banks to lend or to add to the money supply. Constraints to bank lending take two main forms:

- (1.) The Australian prudential regulator, APRA, imposes a number of constraints on banks' balance sheets, in particular by requiring banks to meet certain ratios with respect to (a) the amount of equity and other forms of capital a bank has relative to its risk weighted assets; and (b) other measures that consider the form of its liabilities, in particular the maturity of its liabilities relative to the maturity of its assets (The Liquidity Coverage Ratio and the Net Stable Funding Ratio, amongst others). The result of these constraints is that although Australian banks in aggregate are unconstrained by access to funds - since banks initially create those funds when they lend - their liabilities (including equity) are required to have certain terms and conditions with respect to maturity, subordination, discretion regarding distributions, legal form etc, in order to meet APRA's prudential requirements.

- (2.) As private sector entities, banks are required to make returns for their stakeholders and so will only lend to customers they consider creditworthy. The supply of creditworthy customers is determined by private sector leverage and debt service ratios, and the value of private sector assets available for security (in particular residential housing values).

Implications for the Banks

In aggregate, the ADI balance sheet will always balance, since bank lending adds to the money supply and the central bank neutralises net government spending in order to maintain its interest rate objective. That is, in aggregate, assets and liabilities in the Australian banking system will always be equal since loans create deposits and the central bank will offer assets (CGS) to offset excess reserves created by net government spending.

On an individual ADI basis, each bank's balance sheet will also balance as long as there is a functioning interbank market and the central bank acts as the conduit of last resort for the timely movement of funds from banks with excess funds to banks with funding deficiencies. If the central bank and the interbank market perform such roles, individual banks will never have a deficiency or excess of funds. There can, however, be situations where private banks and the central bank choose not to facilitate the flow of funds to a specific bank, usually when that bank is considered to be at or near the point of insolvency or is generally not considered credit worthy.

On an ongoing basis where all banks are considered solvent and credit worthy, the prudential requirements for banks mean that the form in which funds are lent to banks and the nature of the entity lending those funds is important since different forms of bank liabilities have different impacts on the prudential balance sheet ratios they are required to meet. The final lender to a bank can be in the form of retail individuals, corporate entities, and off-shore entities amongst many others. A bank will breach its prudential requirements if the nature of the entities lending to the bank and / or the terms of the lending are not of the required type, despite having a funded and balanced balance sheet.

In Australia, the majority of lending to banks takes the form of retail deposits. Retail deposits currently account for some two thirds of bank liabilities, although this proportion varies over time. In other economies, this ratio of retail deposits to loans can be significantly higher or lower. The remaining one third of lending to Australian banks comes from domestic corporate entities, domestic government entities, the central bank, foreign retail individuals and corporate entities, and foreign governments amongst other sources. Some "lending" to banks can take the form of common equity investments. These entities act as the final intermediaries (usually in a long chain of intermediaries) between the initial money supply created in the banking system by the bank, when it created an asset, and the final lending of those funds back to that bank so that its balance sheet balances.

Funding (Bank Liability) classification – and implications for the Banking System

In Australia, there are two important types of financial intermediaries or lenders from which banks source some of their liabilities. One is superannuation funds, which represents a large and growing pool of savings. The second is foreign entities, including foreign banks. This source is important due to the aggregate size of the Australian current account deficit.

- *Current Account Deficit*

Under a floating exchange rate regime, the current account deficit is matched by a capital account surplus. This is often referred to as foreign debt - but the term "foreign debt" is misleading.

When a local citizen buys a foreign item, he acquires that item using a foreign currency (say Yen if the item is from Japan). The transaction occurs after swapping existing Australian dollars from an existing deposit account for Yen, so the purchase can be complete. A current account deficit means that there are net buyers of Australian dollars by foreign entities in these transactions. These dollars need to be lent back to the Australian banking system in order to generate a return, either directly or indirectly. There is therefore no requirement to "fund" the current account, and Australia does not rely,

in this sense, on funding from foreign investors. In fact, the banks and the Government are bystanders to the foreign transactions undertaken by local citizens using existing Australian dollars.

However, when foreign entities lend these Australian dollars back to the bank system, the funds are considered “low quality” in terms of the way they impact banks’ prudential ratios.

- *Superannuation funds*

The superannuation system provides a significant source of banks’ liabilities, often with specific terms, particularly short maturities. The reasons for this are discussed further below. Similar to lending from foreign investors, this source of funds is considered low quality for the purpose of prudential ratios.

The reasons the liabilities sourced from superannuation funds are deemed low quality by the bank regulator stem from their short term maturities and the ability and propensity of superannuation funds to withdraw this funding upon real or perceived credit weakness emerging within an individual bank, as well as in response to superannuitants behaviour. Superannuation funds are themselves regulated entities. Since they provide their superannuitants with an ability to withdraw funds and alter asset composition, a material proportion of their own assets need to be held in high liquid format.

Given that a portion of the funding provided to banks is effectively classified as being of low quality by the regulator (including foreign entities and some superannuation deposits as discussed above, but also lending from some corporates, particularly short term lending, as well as interbank lending and other sources), the banks are required to transform the nature of these liabilities, a role which typically falls to the bank’s treasury department. This transformation is achieved by banks borrowing funds in a form that is beneficial from a prudential perspective, typically borrowing with a longer maturity from domestic or off-shore institutional investors. The funds are then used to either repay domestic short term borrowing, or to enter into a swap contract to convert the funds into Australian dollars if the term funding is in a foreign currency. The availability of investors, particularly off-shore investors, to provide funds in such form may be limited at times due to a lack of appetite for risk (interest rate, credit, currency) at given returns. When such appetite is insufficient, banks will still have funded balance sheets since the Australian dollar money supply is not affected but the banks will then need to find other ways to meet their prudential requirements.

The use of currency swaps to convert foreign currency borrowing into Australian dollars is necessary since banks generally prefer to match the currencies of their assets and liabilities to avoid exposure to currency risk. By borrowing from off-shore investors in order to meet prudential requirements, banks (a) increase re-financing risk since non-domestic lenders may choose not to lend to Australian banks; and (b) increase exposure to the credit risk of foreign banking institutions who typically act as swap counterparties in the market for currency swaps.

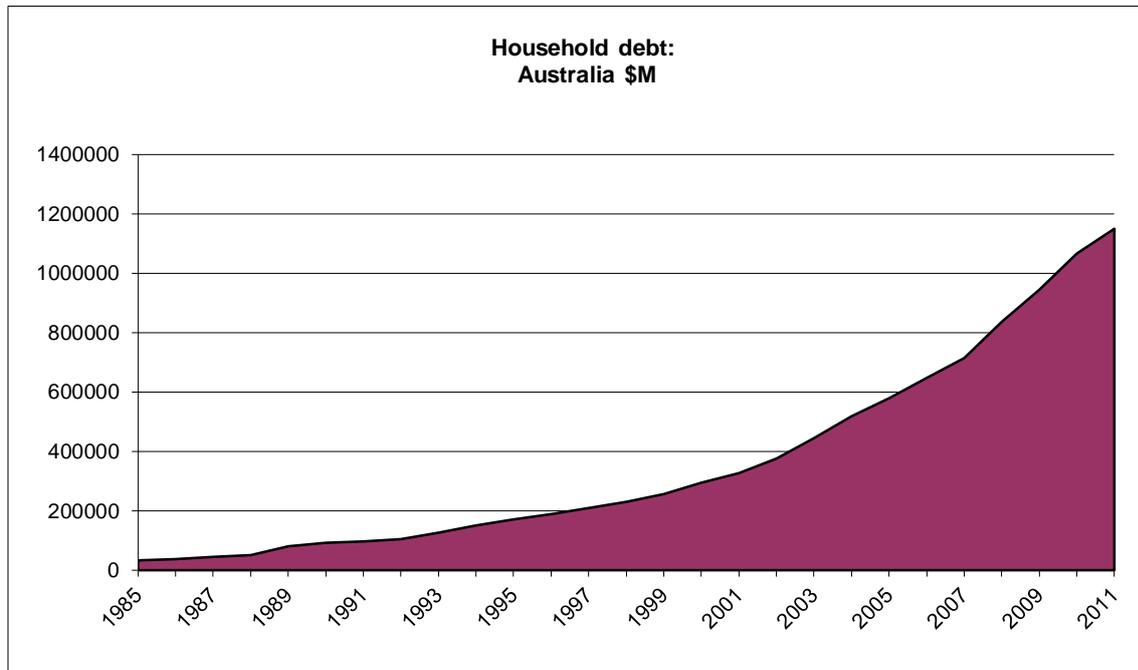
The point to be made is that banks source capital offshore not for funding purposes, but to meet Australian regulatory requirements and this increases the risk to the Australian banking system. The rationale for those regulatory requirements is complex and the subject of much global debate via the Basel Committee review of the banking industry. However, one part of the rationale is to lower the risk of bank failure by lowering the illiquidity risk of banks’ balance sheets, thereby reducing the likelihood of central bank and government support. However, in aggregate, the Australian banking system will always be funded (its balance sheet will always balance). The consequence of these prudential regulations, combined with other structural elements of the Australian economy, is to force the banks to alter the composition of their funding which exposes them to the credit risk of foreign counterparties and re-financing risk of foreign investors.

Interest Rates

One role of the central bank is to set short term interest rates to meet certain inflation objectives (amongst other objectives). By setting interest rates, the central bank plays a key role in encouraging or discouraging the aggregate supply of credit worthy customers for banks, since one important measure of private entity credit worthiness is interest coverage.

The primary effect of lower interest rates (at least in theory) is to encourage new additional borrowings which creates new money (the loan creates the deposit) which in turn increases aggregate demand and stimulates the economy. As discussed above, banks are only constrained in their ability to lend to customers that they consider credit worthy by prudential requirements. The banks therefore act as a transmission mechanism for central bank monetary policy.

But there is a limit as to how much the private sector can accommodate higher debt. Australia has one of the highest proportions of private debt in the world – and the ability for households to take on more financial obligations can become a constraint.



The result is that the central bank has been forced to lower interest rates each cycle, encouraging more private sector debt. As interest rates tend to zero, monetary policy becomes less effective until the lower bound is reached when interest rates are set at zero, as seen in some other advanced countries (Japan, USA, UK etc). At this point some central banks have chosen to undertake less orthodox approaches, including so called quantitative easing. QE is, in effect, an asset swap, designed to lower long term interest rates, although at least in the US, the real impact of QE is debateable, with the effect on the long end of the curve seemingly also subject to other influences. In the US, long dates treasury rates are important as mortgages are often priced using this benchmark, but this is not the case in Australia which makes any consideration of QE far less compelling.

Superannuation

Unspent income (savings) is a leakage of demand. In order for the economy to grow, some part of the economy must spend more than its income to offset these savings – either the government, or the private sector (increased consumption by foreign consumers of Australian goods and services (exports) can also replace the demand). In many countries, savings by households and companies has been accompanied by government deficits. That is, the government spends more than income, so the private sector can spend less than its income. Historically, Australia has had very low government debt, and so in order to contribute to superannuation Australian households have, in effect, been forced to spend and save more than they have earned

Australia's aggregate pool of superannuation has grown significantly since its introduction in the early 1990's and this has resulted in growth in private sector borrowings, as individuals have off-set demand reduction from mandatory savings. This borrowing is often in the form of residential and commercial mortgages. Aggregate

mortgage lending and the total pool of superannuation have grown by similar amounts over time. This growth in bank mortgage lending has been facilitated by a fall in interest rates over the same period which has allowed the supply of credit worthy customers for banks to increase (discussed above). Without lower interest rates, the supply of credit worthy customers would ultimately become exhausted and banks would not be able to increase lending.

As contributions to superannuation increase, so too will demand leakage. This will result in a fall in GDP unless there is increased private and / or public sector debt. The continued ability of the private sector to borrow to offset demand reduction will likely require further interest rate reductions to increase debt capacity. Debt capacity may also become constrained by the stock of housing available for security in mortgages. At some point, increased private sector leverage will not be available to offset reduced demand from mandatory savings and continued contributions to superannuation will result in lower demand and GDP unless offset by increased government demand (budget deficits).

Funding Australia's Infrastructure needs

There appears to be a widely held view that the Australian government is constrained by its budgetary position from providing funds for projects that are considered necessary or worthwhile, including certain infrastructure projects, and further that Australia is overly (dangerously) reliant on non-domestic sources of funds and capital, with the Australian banking system being an important conduit for this capital. The argument runs that this is Australia's "Achilles heel" in that foreign investors (including foreign governments) may choose not to provide Australia with the capital required by reducing their demand for CGS and / or Australian private sector credit (including bank credit), which will have adverse effects on the economy. To offset this, Australia could (or should) continue to enlarge the superannuation sector which provides a potential source of significant capital if properly directed.

This school of thought does not reflect the nature of the Australian financial system.

To reiterate:

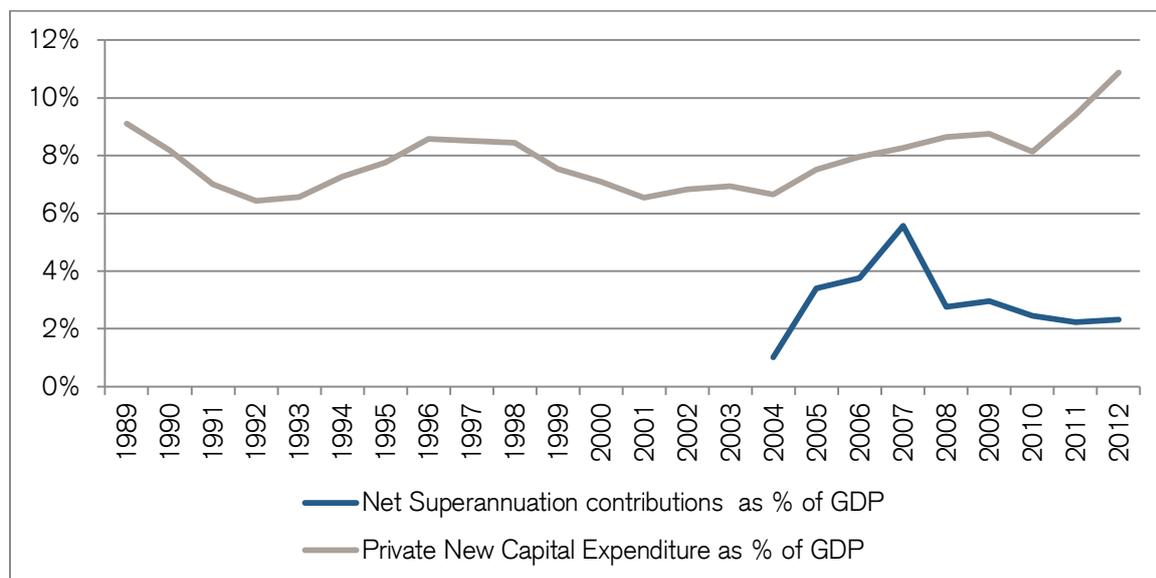
- The Australian economy is a closed system in the sense that Australian dollars can only be spent and invested in Australia
- Almost all investment in Australian projects must take place in Australian dollars, and so any non-domestic investor wishing to invest in Australia must first acquire those Australian dollars
- Foreign investors may provide risk appetite, but they do not provide Australian dollar funding
- Australian banks seek foreign investment to meet domestic regulatory requirements, not because they are short of funds

Projects that meet return hurdles for their risk profile will always attract funding – the Banking system is such that the loan creates the deposit. Any shortfall of investment in Australian projects by private investors, both domestic and foreign, is driven by an adverse assessment of the risk and return profile by those investors, including bank investors. The creation or enlargement of a separate form of private investor – ie domestic superannuation funds – will only contribute to aggregate domestic investment if superannuation funds assess the risk / return equation differently (more aggressively) than other types of investors.

The Australian superannuation system, may lead to superannuation funds having lower investment hurdles by changing the balance between the supply of savings and investment opportunities, which in effect forces superannuation funds to accept lower risk adjusted returns. But as private entities, superannuation funds will choose to maximise returns for a given risk, meaning there is no certainty that a lower return hurdle will mean superannuation funds choose to invest in projects considered to be in the Australian public interest, or even in Australian projects more generally, since super funds are often able to consider non-domestic alternatives. Lower return hurdles will mean lower returns for super-annuitants, and potentially greater exposure for the Australian economy to non-Australian asset prices.

As discussed above, the government is fiscally unconstrained in its ability to provide capital to investments that are considered commercially unacceptable to the private sector, but attractive from a public policy perspective, but must consider the inflationary aspect of so doing.

There is little evidence that the growth in the pool of superannuation assets has led to greater investment in Australia (see chart below).



Superannuation contributions have been recorded by APRA since 2004

The Australian Fixed Income Market

The Australian fixed income market, particularly the corporate bond market, is considered by many people to be sub-scale relative to other countries. One common extension of this view is that having a larger corporate bond market would mean Australian corporates are less reliant on banks to source funds and banks will be less reliant on off-shore bond markets, which would be advantageous for the economy.

The money supply in Australia is determined by government net spending and bank lending, as discussed above. The issue and purchase of a bond instigates a direct lending relationship between the borrower and the lender, usually without any direct involvement of a bank's balance sheet, and therefore without increasing the money supply or changing aggregate private sector leverage, which an equivalent bank loan would do.

A larger corporate bond market would mean a reduced aggregate banking system balance sheet, and reduced money supply relative to direct lending by banks. To the extent a larger money supply is associated with increased private sector demand, this increased demand will be removed. A more developed corporate bond market would not be a source of additional funds for the economy, rather it would mean credit assessment takes place without bank involvement and lending would take place without credit and money supply creation. The impact on aggregate private sector demand and the quality of credit risk assessment by greater bank dis-intermediation should be considered further. It is possible (but not certain) that a corporate bond market may be an effective way to reduce the actual and perceived risk of an investment, relative to bank lending, by increasing the provision of credit information, improving credit assessment due to the direct lending relationship, increasing secondary market liquidity, providing more efficient and transparent price discovery or for other reasons, which may increase the supply of investors willing to assume the risk in Australian projects for a given return. A corporate bond market may also allow banks to carry out their liability transformation more efficiently if bond investors are willing to offer terms that are more attractive from a bank prudential regulation perspective when in bond format (particularly longer term assets) compared to other forms of lending to banks.

If banks were able to carry out the liability transformation process in a domestic bond market, this would reduce the re-financing risk that banks face from exposure to foreign investors, and replace it with the same risk exposure to domestic investors. In both cases, there is no risk that Australian banks cannot source funds to balance their balance sheets as long as the central bank or interbank market is willing to be intermediate the

flow of funds (which already exist), but equally, in both cases, the withdrawal of bond investors (foreign or domestic) will result in banks failing to meet prudential requirements.

The Level of Bank Competition

Banks perform a number of public utility functions in the economy, including maturity transformation, credit assessment and interest rate risk management and act as a transmission mechanism for central bank monetary policy. Despite these public functions, they are, for the most part, profit-driven, private sector entities.

Although the aggregate balance sheet of the banking system will always balance, a necessary feature of an economy with multiple banking entities is the means to ensure the timely flow of funds from banks with excess funds to banks with insufficient funds. This is typically the role of the interbank market. However, the flow of funds will be interrupted when one or more banks are considered to be un-creditworthy by other banks and / or by the central bank. This may happen even when a bank is, in fact, credit worthy, as other banks lack sufficient information to accurately assess credit in a sufficiently timely manner.

Banks are profit driven entities that perform a number of public functions, but cannot exist without government and central bank support. Prudential regulation of banks is designed to ensure bank obligations are always met, within a stable efficient and competitive financial system.

As discussed, the Australian banking system is always funded, meaning its balance sheet always balances. But a reduction in the quality of the assets of an individual bank may result in a lack of funding for that particular bank which would create instability in the Australian financial system. The most important part of bank regulation is therefore the quality of bank assets and the required amount of capital relative to those assets – not the quality of their liabilities.

The level of bank competition directly impacts their appetite to take on credit, interest rate and other risks, ie their asset base. The greater the competition, the greater the risk that will be assumed for a given level of return (or the lower the return for a given level of risk). Increased competition therefore tends to lead to either a deterioration in asset quality if returns are maintained or to lower returns for bank stakeholders if risk and asset quality hurdles are maintained (or a combination of both). Competition in the US played a meaningful role in the growth in sub-prime mortgages. The role of the prudential regulator in monitoring asset quality is therefore very important in guarding against lower asset quality resulting from increased competition.

It is therefore desirable, from a financial stability perspective, for banking competition to be minimised. However, lower competition generally leads to higher profitability for the banking system. Bank profits are essentially a cost for the remainder of the economy, and above normal returns for banks leads to below normal returns for other industries, and to excess resources being deployed in the financial sector. A balance should be struck.

Impact of an Ageing Population

Australia is widely forecast to experience an aging population in future decades, as fertility rates fall and longevity increases, with net immigration expected to at least partially offset this effect. There is much discussion regarding how Australia will fund the increasing size of the non-working population relative to the workforce. Considerations include increasing mandatory superannuation contributions, increasing the retirement age, increasing private contributions to health care costs, amongst many others.

From a financial perspective, a reduction in the proportion of the population in the workforce will lead to lower tax receipts in the absence of any changes to rates of taxation and ongoing government spending, ie to larger annual and aggregate government deficits. However, as discussed above, the government will never be fiscally constrained from continuing to meet its spending obligations and there is no possibility of the country “going broke” as a result of this dynamic, as is sometimes suggested.

There will, however, be greater constraints in the availability of real resources, in particular labour, as the relative size of the work force decreases and the demand for resources from a larger private sector increases. This will likely lead to higher cost of labour, particularly in areas of high demand by the elderly as this demographic

increases in relative size. The social implications and considerations of this should be considered further and might include the encouragement of labour into areas of potentially higher demand (geriatric care, nursing etc), as well as the need to encourage people to stay in the work force until a higher age. Immigration policy will also be important. The issues created by the ageing population should be considered in the context of how to ensure the diminishing supply of labour is best equipped to meet the changing needs of an older population.

Conclusions

- The government is not like a private sector entity, nor is it like a household. The fiscal constraints that apply to private entities do not apply to the Australian government which can issue its own currency.
- Government debt is a private sector financial asset (savings). As a country with a fiat currency and a floating exchange rate, the Australian government can always choose to direct spending on projects it considers worthwhile and can always meet its fiscal obligations. The nominal size of the government's aggregate debt is not a meaningful indicator of economic performance – it is not, and should not be, a constraint on government investment in the economy.
- To support the private sector, government debt should increase in times of reduced aggregate private sector demand and visa versa, meaning the government should act fiscally in a counter cyclical manner. Australian government spending is only constrained by the availability real resources in the economy, and the government's ability to utilise these resources without undesirable inflationary consequences.
- Australian banks, and the Australian economy are not reliant on off-shore investors to source funding. However, current prudential regulatory requirements with respect to banks' liabilities, combined with other structural aspects of the economy, create a requirement for Australian banks to borrow funds from off-shore to transform the nature of their liabilities. While these requirements are designed to safe-guard the financial system, they expose banks to volatility in off-shore economic conditions and capital markets, and introduce greater financial risk to the Australian economy.
- A system of forced savings results in current demand leakage. A larger Australian superannuation system has resulted in higher private sector leverage, lower interest rates and larger government deficits to offset this demand leakage while maintaining or growing GDP. A larger pool of private savings does not increase the availability of "funding" to the economy and has not led to greater investment. Funding is always available in Australia for credit-worthy ventures, with or without superannuation, since banks and the government create that funding so long as it is in Australian dollars.
- Investment in infrastructure and other projects considered to be attractive from a public policy perspective is not constrained by a lack of funding, either public or private. Rather, private investment is constrained by a need to receive commercially acceptable returns. Public investment is constrained by the availability of excess real resources which may be purchased by the government and the effect this may have on price inflation.
- In an economy with an aging population, a system of forced savings, a current account deficit and near zero interest rates, larger government deficits will be required to maintain GDP growth in the absence of a significant to change to the current account position (greater exports).
- Excess competition in the banking system is undesirable and can reduce lending standards and bank asset quality generally since banks are profit driven entities. Potential negative effects for the economy of reduced banking competition should be addressed. A larger Australian corporate bond market may be beneficial to the economy if it leads to a more efficient allocation of risk capital to commercial projects, but it will not provide an additional source of funding to the economy.

Recommendations

- Government annual budgetary considerations should be determined in the context of unemployment and inflation, and should not be influenced by aggregate government debt levels. The objective of the government's fiscal policy should be formalised in a similar manner to the description of the RBA's duty
- Monetary policy and fiscal policy are not independent. A mechanism should be found to allow both to operate in a co-ordinated manner and formalise the equivalency of their objectives
- Mandatory contributions to superannuation should be reduced or stopped
- Banks are quasi-public entities operating in a less than fully competitive environment and bank profitability should be regulated to reflect this. Allowing increased bank competition to reduce profitability is not desirable for financial stability.

- Responsibility for spending on Australian infrastructure should fall to a greater extent on the federal government and should be managed in the context of the government's objectives with respect to unemployment and inflation. Infrastructure spending should form part of the government's budgetary position. Further consideration should be given to mechanisms by which the government can support private sector infrastructure investment (including subsidies, tax breaks, guarantees and other forms of support) that further public policy in terms of infrastructure, employment and inflation