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

26 August, 2014

Dear Sir/Madam,

The following submission addresses a number of the observations, and comments on the policy option recommendations stated in the *Financial System Inquiry Interim Report* (July 2014).

Sincerely,

Troy Lynch PhD

Troy's background is in funds management and academia. He commenced his career at County Investment Management (now Invesco) in a number of roles, including project management, operations and quantitative-equity support activities for the Australian equities team. He then progressed to National Asset Management, where he had the responsibility for the portfolio investment process in international equities, before moving to Australian Unity Investments to support the portfolio management team, which included performance calculation and attribution analysis, master fund analysis, portfolio rebalancing and economic and market commentary. He is currently lecturing and tutoring in economics and finance at a number of institutions.

He holds a PhD in economics (capital and interest theory) from La Trobe University, a Master of Letters (in business cycle theory) from the University of New England, a Bachelor of Economics from Monash University, and completed the Graduate Diploma in Applied Finance and Investment from the Securities Institute of Australia (now Kaplan Professional). He is also a registered representative of the Sydney Futures Exchange (now ASX 24).

Observations and comments on the policy option recommendations stated in the *Financial System Inquiry Interim Report* (July 2014)

Competition and contestability

'Observation: The banking sector is competitive, albeit concentrated. The application of capital requirements is not competitively neutral. Banks that use internal ratings-based (IRB) risk weights have lower risk weights for mortgage lending than smaller authorised deposit-taking institutions (ADIs) that use standardised risk weights, giving the IRB banks a cost advantage.'

I support the suggested policy approach by the Inquiry that would:
'Assist ADIs that are not accredited to use IRB models in attaining IRB accreditation, increase minimum IRB risk weights, introduce a tiered system of standardised risk weights, lower standardised risk weights for mortgages or allow smaller ADIs to adopt IRB modelling for mortgages only.' This would offer greater flexibility and opportunity for risk weighting for smaller ADIs.

The option of 'no change' is unacceptable. The additional evidence the Inquiry seeks is stated in the above proposition, that the industry is dominated by the concentration in revenue earned by the big four banks, the legacy of the Wallis Inquiry. The benefits thus accrue to these institutions implies that 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.

There needs to be more competition in the banking sector. Any implicit Government guarantee or advantage enjoyed by the big four banks must be equally enjoyed by other ADIs or, even better, the absence of favourable conditions that support one or more ADIs to the disadvantage of another. The dominance of the big four banks must be reduced and further competition promoted.

I oppose the suggested policy approach by the Inquiry to:
'Provide direct Government support to the RMBS market, or allow RMBS to be treated as a high-quality liquid asset for the purpose of the liquidity coverage ratio.' The lower the government intervention in this market, the greater is the possibility for the market to resolve RMBS funding requirements. Also, suggesting that RMBS acts as a proxy for a liquid asset will only fuel greater opportunity for an already over-provided debt market for mortgages and for housing in general. RMBS should not be treated as a high-quality liquid asset; the implications for this during a downturn and asset re-pricing cannot be justified.

'Observation: Regulation of credit card and debit card payment schemes is required for competition to lead to more efficient outcomes. However, differences in the structure of payment systems have resulted in systems that perform similar functions being regulated differently, which may not be competitively neutral.'

I support the suggested policy approach by the Inquiry that would lead to:
'No change to current arrangements.'

Funding Australia’s economic activity

‘Observation: Ongoing access to foreign funding has enabled Australia to sustain higher growth than otherwise would have been the case. The risks associated with Australia’s use of foreign funding can be mitigated by having a prudent supervisory and regulatory regime and sound public sector finances.’

‘Observation: There are structural impediments for small- and medium-sized enterprises to access finance. These impediments include information asymmetries, regulation and taxation.’

I support the suggested policy approach by the Inquiry that would lead to:
‘No change to current arrangements.’

I oppose the suggested policy approach by the Inquiry to:
‘Facilitate development of a small- and medium-sized enterprise finance database to reduce information asymmetries between lenders and borrowers.’ While in principle the intent and reason for its existence seems to be an admirable solution, such a solution would be better handled by the market, as it seeks to provide quality information. I oppose the creation of an entity for the purpose of the creation of such a database.

‘Observation: Australia has an established domestic bond market, although a range of regulatory and tax factors have limited its development.’

I support the suggested policy approach by the Inquiry that would:
‘Allow listed issuers (already subject to continuous disclosure requirements) to issue ‘vanilla’ bonds directly to retail investors without the need for a prospectus.’ This would provide greater flexibility and opportunity for corporate funding as well as risk-weighted and market-evaluated products that could be enjoyed by the retail investor.

I support the suggested policy approach by the Inquiry that would:
‘Review the size and scale of corporate ‘vanilla’ bond offerings that can be made without a prospectus where the offering is limited to 20 people in 12 months up to a value of $2 million, or for offers of up to $10 million with an offer information statement.’

Superannuation efficiency and policy settings

‘Observation: There is little evidence of strong fee-based competition in the superannuation sector, and operating costs and fees appear high by international standards. This indicates there is scope for greater efficiencies in the superannuation system.’

I support the suggested policy approach by the Inquiry that would move:
‘from the current prescription-based approach for portability of superannuation benefits to a principles-based approach.’ This may introduce greater flexibility and a movement away from the demand for liquid assets.

‘Observation: If allowed to continue, growth in direct leverage by superannuation funds, although embryonic, may create vulnerabilities for the superannuation and financial systems.’

I oppose the suggested policy approach by the Inquiry that would:
'Restore the general prohibition on direct leverage in superannuation on a prospective basis.' Superannuation funds should possess the responsibility of market restraint and responsibility as an investor of public funds to engage in an appropriate level of leverage. Imposing a control relinquishes responsibility in favour of an arbitrary government regulator's choice of leverage, which is not market determined, and which is otherwise incorrect, impositional and arrogates more power to regulatory authorities.

'Observation: Superannuation policy settings lack stability, which adds to costs and reduces long-term confidence and trust in the system.' I support mechanisms that will reduce fees, enhance fee-based and performance-based competition and restraints on the downward movement of administration costs.

Stability and the prudential framework

'Observation: During the GFC, significant government actions in a number of countries, including Australia, entrenched perceptions that some institutions are too-big-to-fail. These perceptions can be reduced in Australia by making it more credible to resolve these institutions without Government support.'

I strongly oppose the suggested policy approach by the Inquiry that would:
'Increase the ability to impose losses on creditors of a financial institution in the event of its failure.'

The *Banking Act 1959* (Cth) or other legislation should not 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.'[1]

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.

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

It is also morally reprehensible, because it is theft.

That it is even raised as a possibility by institutions such as the US Federal Deposit Insurance Corporation and the Bank of England, and the G20, reveals how far liberal democracies have strayed from asserting with sound moral judgement the principle of private property in favour of state-based solutions that shift responsibility away from those to whom responsibility rests, the shareholders, to those whose funds it has a fiduciary responsibility to manage with discretion and proprietary, the depositors. The responsibility should be borne solely by shareholders, and not taxpayers or depositors.

This proposal is asserted because previously it was the expectation that losses in financial institutions should be borne by taxpayers, for systematically important domestic financial institutions. This creates moral hazard, facilitates excessive risk bearing by such institutions, affirms the working principle that they are too big to fail, creates an expectation by the investing public, the shareholders, that this is not a private but a quasi-nationalised industry which can operate with a tacit and implicit government guarantee, and expand credit beyond the normal constraints of institutions that are not otherwise supported by taxpayers' money.

The following proposition is too open-ended: 'Strengthen regulators' resolution powers for financial institutions, and invest more in pre-planning and pre-positioning for financial failure.'

However, I strongly oppose the suggested policy approach by the Inquiry that would allow resolution powers that utilise government, taxpayer, depositor or other private monies for such action. That is, resolution should also include unequivocal bankruptcy of financial institutions, including the largest national bank and insurance companies – systematically important domestic financial institutions – in the event of the failure for revenues to cover costs. This loss should be borne by shareholders. In the event of commercial failure, which results in bankruptcy, the assets should be sold off and creditors paid. This should not be a power allocated to ASIC, the RBA or another other public institution to use public or private (taxpayer) monies to resolve normal operational market problems of such institutions:

I strongly support the suggested policy approach by the Inquiry that would:
'Further increase capital requirements on the financial institutions considered to be systemically important domestically.' To constrain unfettered credit expansion in the domestic economy via the process of fractional reserves, a greater proportion of creditors (depositors) funds should be retained in reserve, beyond the limits of Basel III (or the Third Basel Accord).

I support the suggested policy approach by the Inquiry that would:
'Ring-fence critical bank functions, such as retail activities' if that would compel them to carry more regulatory capital, but not if it would also impose on creditors the responsibility for failed bank losses; the latter should only be borne by shareholders. I support ring fencing that forces lenders to separate deposit-taking from their riskier activities.

'Observation: A number of jurisdictions have implemented new macroprudential toolkits to assist with managing systemic risks. The effectiveness of these for a country like Australia is not yet well established, and there are significant practical difficulties in using such tools.'

I support the suggested policy approach by the Inquiry that would:

‘Establish a mechanism, such as designation by the relevant Minister on advice from the Reserve Bank of Australia (RBA) or the Council of Financial Regulators (CFR), to adjust the prudential perimeter to apply heightened regulatory and supervisory intensity to institutions or activities that pose systemic risks.’

I support the suggested policy approach by the Inquiry that would:
‘Introduce specific macroprudential policy tools.’ This should not otherwise be required and it would be a second-best policy choice. However, in an era of fiat (i.e. state determined) money and credit expansion, the regulatory authorities have failed to allow the market to correct itself: the imposition of a central bank overnight lending interest rate, the cash rate, set by the RBA, rather than a market rate of interest determined by the market, allows the free expansion of credit beyond the level of available savings. This encourages reckless credit expansion, excessive borrowing and debt, and higher levels of risk. One area this impacts is the credit for mortgages.

If implemented, macroprudential policy rules should constrain excess investment in residential property, particularly existing residential property (but not new residential property). This could be curbed by compelling investors to provide a minimum deposit of, for example, 20%.

‘<u>Observation</u>: Australia has implemented some aspects of global prudential frameworks earlier than a number of jurisdictions. It has also used national discretion in defining capital ratios. When combined with other aspects of the prudential framework and calculated on a consistent basis, Australian banks’ capital ratios (common equity tier 1) are around the middle of the range relative to other countries. However, differences such as those in definitions of capital do limit international comparability.’

I strongly support the suggested policy approach by the Inquiry that would:
‘Calibrate Australia’s prudential framework, in aggregate, to be more conservative than the global median. This does not mean that all individual aspects of the framework need to be more conservative’ and ‘[d]evelop public reporting of regulator-endorsed internationally harmonised capital ratios with the specific objective of improving transparency.’

Notwithstanding that Australia has middle of the range capital ratios, I have argued above that Australia has engaged in credit expansion, which has been facilitated by the nature of fractional reserve banking. This has witnessed an excessive level of credit expansion, most of which has flowed in the recent decade or more into unproductive assets such as equities and residential properties. This has led to excessive private debt-to-income and residential prices that are beyond the reach of the average wage earner.

While the unforeseen cannot usually happen, an extreme risk is the possibility that interest rates could rise beyond the expected and foreseen level. This would place individuals and banking system, as well as the housing market, at an unnecessary risk. Credit expansion can be curtailed via the use of more stringent capital controls. This may lead to higher banking costs, but it would also facilitate more sound credit institutions and lending practices.

‘<u>Observation</u>: To contribute to the effectiveness of the financial system, sound corporate governance requires clarity of the responsibilities and authority of boards and management. There are differences in the duties and requirements of governing bodies for different types of financial institutions and, within institutions, substantial regulator focus on boards has confused the delineation between the role of the board and that of management.'

I support the suggested policy approach by the Inquiry that would:
'Review prudential requirements on boards to ensure they do not draw boards into operational matters' and 'Regulators continue to clarify their expectations on the role of boards.'

Consumer outcomes and conduct regulation

'Observation: The current disclosure regime produces complex and lengthy documents that often do not enhance consumer understanding of financial products and services, and impose significant costs on industry participants.'

I support the suggested policy approach by the Inquiry that would:
'Improve the current disclosure requirements using mechanisms to enhance consumer understanding, including layered disclosure, risk profile disclosure and online comparators.'
'Remove disclosure requirements that have proven ineffective and facilitate new ways of providing information to consumers, including using technology and electronic delivery.'

'Consider a move towards more default products with simple features and fee structures.'
This latter approach would provide the opportunity for a more rigid approach, though streamlined in nature; it would be an alternative in the case the first point on improving the current disclosure becomes unwieldy.

I oppose the suggested policy approach by the Inquiry that would:
'Provide the Australian Securities and Investments Commission (ASIC) with additional product intervention powers and product banning powers.'

'Observation: Affordable, quality financial advice can bring significant benefits for consumers. Improving standards of adviser competence and removing the impact of conflicted remuneration can improve the quality of advice. Comprehensive financial advice can be costly, and there is consumer demand for lower-cost scaled advice.'

I support the suggested policy approach by the Inquiry that would:
'Enhance the Australian Securities and Investments Commission's power to include banning individuals from managing a financial services business.'
'Rename general advice as 'sales' or 'product information' and mandate that the term 'advice' can only be used in relation to personal advice.'

Regulatory architecture

'Observation: Australia generally has strong, well-regarded regulators, but some areas of possible improvement have been identified to increase independence and accountability.'

I support the suggested policy approach by the Inquiry that would:
'Conduct periodic, legislated independent reviews of the performance and capability of regulators. Clarify the metrics for assessing regulatory performance. Improve the oversight processes of regulators.'

‘Observation: During the GFC and beyond, Australia’s regulatory coordination mechanisms have been strong, although there may be room to enhance transparency.’

I support the suggested policy approach by the Inquiry that would lead to:
‘No change to current arrangements.’

‘Observation: Regulators’ mandates and powers are generally well defined and clear; however, more could be done to emphasise competition matters. In addition, ASIC has a broad mandate, and the civil and administrative penalties available to it are comparatively low in relation to comparable peers internationally.’

I support the suggested policy approach by the Inquiry that would lead to:
‘No change to current arrangements.’

‘Observation: To be able to perform their roles effectively in accordance with their legislative mandate, regulators need to be able to attract and retain suitably skilled and experienced staff.’

I support the suggested policy approach by the Inquiry that would lead to:
‘Review mechanisms to attract and retain staff, including terms and conditions.’

Retirement incomes and ageing

‘Observation: The retirement phase of superannuation is underdeveloped and does not meet the risk management needs of many retirees.’

I support the suggested policy approach by the Inquiry that would:
‘Provide policy incentives to encourage retirees to purchase retirement income products that help manage longevity and other risks.’

‘Observation: There are regulatory and other policy impediments to developing income products with risk management features that could benefit retirees.’

I support the suggested policy approach by the Inquiry that would:
‘Take a more flexible, principles-based approach to determining the eligibility of retirement income products for tax concessions and their treatment by the Age Pension means-tests.’
‘For product providers, streamline administrative arrangements for assessing the eligibility for tax concessions and Age Pension means-tests treatment of retirement income products.’

I oppose the suggested policy approach by the Inquiry that would:
‘Issue longer-dated Government bonds, including inflation-linked bonds, to support the development of retirement income products.’

Technology opportunities and risks

‘Observation: Technological innovation is a major driver of efficiency in the financial system and can benefit consumers. Government and regulators need to balance these benefits against the risks, as they seek to manage the flexibility of regulatory frameworks and the regulatory perimeter. Government is also well-positioned to facilitate innovation through coordinated action, regulatory flexibility and forward-looking mechanisms.'

I support the suggested policy approach by the Inquiry that would:
'Amend regulation that specifies using certain technologies with the aim of becoming technology neutral. Amendments should enable electronic service delivery to become the default; however, they should include opt-out provisions to manage access needs for segments of the community.'
'Adopt a principle of technology neutrality, for future regulation recognising the need for technology-specific regulation on an exceptions basis. Where technology-specific regulation is required, seek to be technology neutral within that class of technologies.'

I oppose the suggested policy approach by the Inquiry that would:
'Establish a central mechanism or body for monitoring and advising Government on technology and innovation. Consider, for example, a public-private sector collaborative body or changing the mandate of an existing body to include technology and innovation.'
'Establish a whole-of-Government technology strategy to enable innovation. '

'<u>Observation</u>: Access to growing amounts of customer information and new ways of using it have the potential to improve efficiency and competition, and present opportunities to empower consumers. However, evidence indicates these trends heighten privacy and data security risks.'

I support the suggested policy approach by the Inquiry that would:
'Review and assess the new privacy requirements two years after implementation to consider whether the impacts appropriately balance financial system efficiency and privacy protections.'

I oppose the suggested policy approaches by the Inquiry that would:
'Review record–keeping and privacy requirements that impact on cross-border information flows and explore options for improving cross-border mutual regulatory recognition in these areas.'
'Implement mandatory data breach notifications to affected individuals and the Australian Government agency with relevant responsibility under privacy laws.'
'Communicate to APRA continuing industry support for a principles-based approach to setting cloud computing requirements and the need to consider the benefits of the technology as well as the risks.'

'<u>Observation</u>: The financial system's shift to an increasingly online environment heightens cyber security risks and the need to improve digital identity solutions. Government has the ability to facilitate industry coordination and innovation in these areas.'

I support the suggested policy approaches by the Inquiry that would:
'Review and update the 2009 Cyber Security Strategy to reflect changes in the threat environment, improve cohesion in policy implementation and progress public–private sector collaboration.'
'Develop a national strategy for promoting trusted digital identities, in consultation with financial institutions and other stakeholders.'

International integration

'Observation: Although elements of Australia's financial system are internationally integrated, a number of potential impediments have been identified. Financial system developments in the region will require continuing Government engagement to facilitate integration with Asia.'

'Observation: Government efforts to promote Australia's policy interests on international standard setting bodies have been successful. Domestic regulatory processes could be improved to better consider international standards and foreign regulation, including processes for collaboration and consultation about international standard implementation, and mutual recognition and equivalence assessment processes.'

I support the suggested policy approach by the Inquiry that would:
'Improve domestic regulatory process to better consider international standards and foreign regulation — including processes for transparency and consultation about international standard implementation, and mutual recognition and equivalence assessment processes.'

'Observation: Coordination of Australia's international financial integration could be improved.'

I support the suggested policy approach by the Inquiry that would:
'Amend the role of an existing coordination body to promote accountability and provide economy-wide advice to Government about Australia's international financial integration.'

I wish to also reiterate propositions that I presented in the first-round submission to the Financial System Inquiry.

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 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 accept the risk of their action (and those of their representatives who operate the entity), but not the public, creditors 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’[2]

Superannuation funds

The existing stock of superannuation funds – at present, approximately $1.7 trillion – should not be available for government-directed or government-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

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

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.

Notwithstanding the basic definition of theft as a 'person [who] steals if he dishonestly appropriates property belonging to another with the intention of permanently 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

[3] *Banking Act 1959* (Cth) s 40(2).
[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).

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 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

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

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.