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TITLE: **More pulp fiction from the banks**

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There is nothing more profitable for the banks than confusion about what they do. As long as they keep talking about acronyms no one has heard of and financial theories that no one understands, they can continue the enormously profitable business of borrowing money at low rates and lending it at high rates. This year alone the result of this strategy will generate after tax profits worth more than $22 billion, more than $1000 for every man woman and child in the country.

The problem for the banks, however, is that they are finally being asked some hard questions about their simple strategy, and the answers haven't been pretty.

The hardest, and from the banks' point of view the most heretical, question is the one that Steven Munchenberg from the Australian Bankers Association fumbled so badly in today's Sydney Morning Herald: that is, why do banks even need to increase mortgage interest rates in line with movements in official interest rates?

While it may seem like common sense that the banks should pass on official interest rate rises, a closer look shows that this need not be the case. Banks borrow money from a range of sources including the Australian money market (on which they pay the official interest rate), foreign money markets (where Japanese prime rates are still below 2.5% and US prime lending rates have been stuck at 3.25% for the past two years) and from their customers' deposits (on which they often pay zero interest or charge us for the privilege of banking with them).

Consider the following example. Imagine you were making a banana smoothie and the cost of making it were evenly divided between milk, bananas and ice-cream. If the price of bananas doubled, the price of the banana smoothie wouldn't need to double. In fact the cost of the smoothie should only need to rise by a third.

Of course, the banks argue that the costs of their foreign borrowings are rising as well, but given that most developed countries are fighting off double-digit unemployment, what are the chances that their interest rates are rising faster than ours? The ABS Balance of Payments figures suggest the cost of foreign borrowings is actually falling. If the banks have some clear data that contradicts the national accounts, they should put it on the table.

Yesterday The Australia Institute's David Richardson analysed the latest APRA data and found that while the official interest rate rose by 136 basis points between the June quarter 2009 and the June quarter 2010, the banks' cost of funds from all sources increased by only 88 basis points. The Bankers Association's response to this finding was as humorous as it was illogical. According Munchenberg:

"To be honest we can't work this out. Performing the same calculation we get the same result but I know it is not right because if it was we would have been being beaten to a pulp with this by the government and the opposition."

So the fact that the major political parties have been slow to get to the bottom of the bank's obfuscation is, we are lead to believe, a compelling reason for ignoring the simple story revealed in the complex APRA data.

Earlier this week The Australia Institute estimated that the decision to lift mortgage rates over and above the official interest rate rise would net the banks an extra $1.2 billion in profit in a full year. It's pretty simple to see why the bank CEOs are getting such big bonuses.

Australia's banks are very big, very profitable and very powerful. By definition, therefore, they cannot be highly competitive. Highly competitive industries are characterised by having lots of small firms competing fiercely with each other on price to keep prices and profits low.

What we have in Australia is an enormously profitable oligopoly with some small competitors fighting for the scraps that fall from the table. It is economically meaningless to describe it as "highly competitive" and it is politically meaningless to suggest that anything can be done to protect personal and small business customers without introducing new regulations.

But if the banks are right and there is nothing that governments can do to reduce their profits through regulation, then we should simply tax the excess profits away. Banking super profits tax anyone?

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