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Submission to the financial services review

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TAI

Submission

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Introduction

> But underlying many of these [policy mistakes], in both the public and private sectors, were the economic philosophies that have prevailed for the past quarter century (sometimes referred to as neoliberalism or market fundamentalism). *Stiglitz, UN Committee.*[1]

We refer to the committee chaired by Stiglitz in more detail below but want to make the clear point at the outset that world opinion today is much less in favour of a pro-market approach to finance than it was perhaps on the eve of the global financial crisis. And if there is less of a pro-market approach there is even less of a pro-business approach. We distinguish pro-market and pro-business because incumbent business likes to confuse the two while a pro-market approach may well be anathema to big business. Luigi Zengalis, a professor of finance at the University of Chicago Booth School of Business, paints a picture of a crony capitalism where big business is mistaken for 'the market' and, in collusion with politicians, arranges for the elimination of competition and the capture of the state to deliver benefits through government contracts and tax cuts for the rich as well as specific regulation/deregulation packages. In 2012, he was named by *Foreign Policy* magazine to its list of FP Top 100 Global Thinkers, 'For reminding us what conservative economics used to look like'.[2]

We see the problem Zengalis identifies as applying to banking and finance in Australia and note that each of the big four banks regularly have on their boards former heads of Treasury and the Reserve Bank. We do not think that crony capitalism is as advanced in Australia as it is in the US but the dangers are there. However, while the chair of the present committee was once CEO of the Commonwealth Bank we note that in an interview on ABC radio he referred to the big banks as 'monsters'. In his words:

> *banks fund most of the assets in the economy - whether it's businesses, governments themselves, homes or projects, whatever else. And because they do that, banks in aggregate are themselves monsters … They have monstrous balance sheets and therefore they make a lot of profit.*[3]

David Murray is correct. Big business dominates the Australian economy with the sales revenues of the top 50 non-financial corporations equal to 34 per cent of the Australian economy which amounts to around 44 per cent of all private sector activity in Australia.[4]

We note that the terms of reference invite the committee to favour a deregulatory position with invitations to 'foster a … flexible financial system…' and the instruction to assess the 'effectiveness and need for financial regulation' and make recommendations 'conducive to dynamic and innovative financial service providers'. This seems especially curious given that the global financial crisis made it abundantly clear that it was precisely deregulation and innovative financial products that were at the root of the problem. The IMF has also pointed out there is a strong case for taxes on activities with negative externalities such as excessive risk-taking in the financial sector.[5] This issue will be taken up further below.

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[1] Commission of Experts of the President of the United Nations General Assembly on Reforms of the International Monetary and Financial System (2009) *Report*, NY: United Nations

[2] Zengalis L (2012) *A Capitalism for the People: Recapturing the Lost Genius of American Prosperity,*

[3] AM (2012) 'Interview: Future fund chair and banks resist Swan rates pressure', *ABC radio*, 7 February,

[4] See Richardson D (2013) 'Corporate power in Australia', *Paper given to 12th Australian Society of Heterodox Economists Conference*, University of New South Wales, 2-3 December.

[5] Ostry JD, Berg A and Tsangarides CG (2014) Redistribution, inequality and growth', IMF Staff Discussion Note 14/02, February.

In this introductory section it is also worth noting the comments in a recent study of the dysfunctions in the financial system as they developed in the US leading up to the global financial crisis. The authors point to the 'legally and ethically dubious behaviour in generating the current and past financial crises' and noted that 'most Americans engage in some law-breaking on a daily basis. We should not expect business people and financiers to behave any differently'. The examples listed for ordinary Americans include 'jaywalking, to hiring illegal gardeners and nannies, to not paying social security taxes on legal domestics, to doing drugs, to cheating on taxes, to getting disability benefits when there is no disability, to speeding, to insurance fraud, and so on'. And if business people are equally disposed to flirt with the law then the 'few bad apples' theory usually invoked to explain unsocial behaviour is vastly inadequate.[6] We cite this in particular to contrast with the implicit view that government can safely deregulate the financial system confident in the knowledge that there are market forces that constrain participants to be 'good'.

Reinforcing the view put here one observer in a work funded by the European Union has said:

> *The exact content of regulatory failure, in this perspective can be summarised in one word: deregulation. Given the culture of greed that inevitably characterises financial markets, deregulatory measures…directly caused the crisis'.*[7]

The Australia Institute has published a number of papers on aspects of the finance industry with links provided in an appendix to this paper. Those papers are to be read as forming part of this submission.

The terms of reference call for a 'root and branch' review of the financial system. That is a major task and would strain the resources of an inquiry ten times the size of the present and with ten times the time to report.

General issues

In an address to CEDA the chair of the Committee of inquiry into the financial system, David Murray, pointed out that:

> *The growth in financial assets of Australian Governments, businesses and households has averaged 9 per cent since 1996; growth in banks' holdings of financial assets has averaged nearly 11 per cent over the same period. Over the same period, the average annual growth in nominal GDP has been about 6.5%.*

The implication of those figures is that the value of financial assets has increased its share of GDP by 50 per cent while bank assets have increased to over twice its earlier share of GDP. Some of the increases may be explained by the increase in asset prices relative to the price of goods and services in Australia. The even stronger increase in bank assets may be also due to banks squeezing out competitors and/or increasing 'intermediation'. The latter refers to the increasing number of entities between the ultimate savers and the ultimate investors/borrowers.

It is not sustainable for any economic magnitude to grow more quickly than GDP for any length of time. Herbert Stein's law says 'If something cannot go on forever, it will stop'. The important question is how it might stop.

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[6] Quotes are taken from McCarty N, Poole KT and Rosenthal H (2013) *Political Bubbles: Financial Crises and the Failure of American Democracy*, Princeton and Oxford: Princeton University Press,

[7] Notermans T (2013) 'Reforming finance: A literature review'*, Financialisation, economy, society and sustainable development, No 8 working paper series.*

An important and often related issue is that debt is often used to finance speculation that may have a large harmful impact when the price increases come to an end—as they inevitably do. Debt financed asset price increases are often a good example of ‘things that cannot go on forever, [and] will stop’. Debt according to *The Economist* is useful, in theory, if it allows business to accumulate capital or consumers to smooth their consumption over their lives. In practice, however, debt is used to finance the purchase of existing assets, leading to bubbles. A former Bank of England official cites an estimate that only 15 per cent of British bank lending is used for capital investment.[8]

The phenomenon of the boom and bust of US housing debt associated with the global financial crisis has reawakened interest in the views of Hyman Minsky, an American economist who described the characteristics of financial crises.

Consumer issues

In the introduction we mentioned that there is indeed a tendency for criminal and close to criminal behaviour in the financial sector. Even President John F. Kennedy once proclaimed, "My father always told me that all businessmen were sons of bitches".[9]

If a consumer has a bad time with a plumber, a meat pie or any normal good or service the answer is to search around and find another supplier next time. However, we have a financial system in which people often find themselves with large lump sums to invest and have little knowledge of the industry they have to deal with.[10] This is a one-off event and it is not possible for the customer to readjust and deal with better people next time. Rather there has to be a regulatory and legal response which would outlaw such behaviour and monitor the industry to ensure it does not happen. Instead the opposite seems to be happening.

Returning to the American authors mentioned earlier, they point out that ‘politicians observe no taboo against singling out some categories of Americans as having a proclivity for crime; why not the financial services industry? Undoubtedly because the industry packs the political power and can deliver rewards to the Phil and Wendy Gramms [who were] far from unique’.[11]They also point out that there is a curious dynamic. When some in the industry sail close to the wind or even break the law the more honest of their competitors are naturally upset at the unfair competition. However, rather than seeking to enforce the law more strictly or ban close-to-illegal practices they tend to lobby for eliminating the regulations that prescribe the relevant behaviour in the first place. In that way there is a push for deregulation.

As many people have stressed, including Stiglitz above, there is often a major imbalance between the parties to a financial transaction. People purchase products from advisors who appear to be honest and acting in the customers best interests. But it is more than just the different degree of sophistication of the parties to a transaction. It is likely that the purchasers of sophisticated mortgage backed securities (MBSs) and the ratings agencies that rated them were just as sophisticated as the people who packaged the mortgages. However, it was the latter that were in a position to know exactly what was being packaged into the MBSs and it was not in their interests to divulge exactly what was going on.

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[8] Buttonwood (2014) *The Economist,* 25 Jan

[9] McCarty N, Poole KT and Rosenthal H (2013) *Political Bubbles: Financial Crises and the Failure of American Democracy*, Princeton and Oxford: Princeton University Press,

[10] Often these come from a large super pay out and there is a potential answer in requiring tax-payer assisted super pay-outs to be reinvested in retirement products.

[11] McCarty N, Poole KT and Rosenthal H (2013) *Political Bubbles: Financial Crises and the Failure of American Democracy*, Princeton and Oxford: Princeton University Press, p. 75. Phil and Wendy Gramms were implicated in the Enron scandal.

The present initiatives in favour of deregulation in Australia are a serious concern. Even in the absence of differences in information between buyer and seller there remains an important power imbalance. The purchaser of a home or other large item is usually keen to borrow while on the other hand the lender is only interested to the extent that there is a profit to be made. That power imbalance alone is enough to warrant a public policy interest in the transactions being made.

When it comes to superannuation it is worth pointing out that we are not aware of any other retirement scheme in the world that is either compulsory or subsidised that does not in one way or another guarantee that retirement savings are earmarked for retirement incomes. A major deficiency in the Australian system is that it fails to guarantee that and instead relies on people with no expertise to make arrangements for their own retirement or not as the case may be. But even with the best will in the world people fail or are subject to fraud.

The fact that even sophisticated investors run into problems means that the old approach of ‘buyer beware’ is completely inadequate. Government actions are required to ensure the quality of the product and the conduct of the characters in the industry. A particular and immediate concern is the current attempt to water down some of the restrictions on financial incentives for financial advisors. The present inquiry will probably not want to get into the detail of the legislation but it should produce some guiding principles on the need to address in particular the information asymmetry.

The recent judgement in the case of the class action against the ANZ bank suggests banks are ever willing to use whatever excuse they can invent to derive more income from customers. Banks are too willing to impose extra-judicial ‘penalties’ on the behaviour of their customers, whether that involves getting out of some mortgages or late payments and over-drawing from accounts.

We note that banks, especially the big banks, encourage and/or incentivise staff to push products on customers. At the other end of the industry we have had a long history of reports on the ABC’s 7.30 Report and various other media which has examined the informal and criminal behaviour of those offering financial advice. There seems to be some wisdom in the views of McCarty et al cited above who see the potential for criminal and near criminal behaviour when regulation is loose. That is not necessarily to suggest that existing players are suspect but that if there are opportunities they will be quickly seized by less savoury characters.

While rejecting the buyer beware approach it is also important that people, especially those retiring and about to retire, have some elementary skills so that they can manage their super payouts and other funds about to come under their control. A financial literacy strategy triggered by withdrawals from accumulation super funds would be a worthwhile addition to the Australian financial system.

Some consumer protection issues more specific to banks are taken up in the following section.

Banking

In March 2010 we published a paper *A licence to print money: bank profits in Australia* which drew attention to the extreme profitability of the Australian banks with underlying profits of just under three per cent of GDP. That meant that for every dollar spent in Australia, three cents ended up as pre-tax profits of the big four banks. The extreme profitability and the high target rates of return sought by the banks have adverse consequences for those who rely on banking services.

Years ago we had the big debate about banks closing down bank branches, including in remote and regional centres, that were ill-served by banking. A former governor of the Reserve Bank, Ian Macfarlane, made the point that by aiming for very high rates of return the banks were not investing in many things that would have been profitable, but were not able to reach hurdles of 18 to 20 per cent, or 26 to 29 per cent before tax. One consequence is that the big banks closed branches that, while still profitable, were not profitable enough.[12] Banks have made it less convenient for customers to undertake their banking even though the branches in question had remained profitable.

This is a serious problem and is not unique to banks. Investment is a major contribution to Australia's economic growth and the rise in living standards over time. In a competitive market we expect that business will continue to invest as long as they make a reasonable return. However, the banks put such a high hurdle on investments that they ignore investment opportunities that would otherwise contribute to overall wellbeing in Australia. This illustrates one of the many ways in which the existence of monopolies[13] and oligopolies acts as a burden on the economy as a whole. It means that profitable investments that could benefit the country as a whole will potentially go wanting because private investors want higher rates of return. There is no logic to the predisposition to leave everything to the market because there are bound to be cases where that does not advance the national interest. Indeed, many Australians may prefer to deal with a government owned organisation just as others may prefer a member-owned organisation. If there are no government-owned organisations then arguably the government is denying consumers their right to choose among different types of organisation.

Contributing to the profitability of the banks is the high concentration of banking in Australia. *A licence to print money* points out that competition has been the main weapon used by policy makers over the years, indeed going back at least as far as the 1840s inquiry by the NSW Parliament. However, the Australian banks have thrived on competition and deregulation, increasing their share of the finance industry from around half in the 1970s to well over 90 per cent now. Over the last century we have seen experiments with a 'people's bank'[14], building societies and credit unions, foreign banks and attempts to empower consumers. *A licence to print money* suggests that competition has failed and suggests technical factors such as economies of scale, network economics and domination of the payments system has meant large banks have a natural advantage. Only the four pillars policy acts to prevent an even more concentrated industry. Some of the specific recommendations in *A licence to print money* have since been implemented but there are other policies that should be examined. For example, a separation of the payments system functions from the lending business was first suggested there and found echoes in a later proposal from Professor Ian Harper.[15] Harper suggested the government should find ways of promoting 'competitive neutrality so that it [the mutual structure] can compete unimpeded with the listed bank model'.[16]

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[12] See Macfarlane I (1999) 'Transcript of evidence', House of Representatives, Standing Committee on Economics, Finance and Public Administration Inquiry into Reserve Bank of Australia annual report 1997–98, Melbourne, Thursday 17 June. Available at:

http://www.aph.gov.au/hansard/reps/commttee/R2365.pdf.

[13] This paper does not use a definition of monopoly as strictly a sole seller unless that is clear in the context. Rather monopoly in this paper may refer to many different forms of imperfect competition. We prefer to regard monopoly not as an either or concept but one of degree. In that regard not the concept of monopolistic competition after EH Chamberlin and which is described in most microeconomic textbooks.

[14] Australia's people's banks were established by some of the colonies (South Australia, Tasmania and Victoria) and later the Commonwealth Bank by the national government.

[15] Deloitte Access Economics (Ian Harper) (2012) *Competition in banking*

[16] Deloitte Access Economics (Ian Harper) (2012) *Competition in banking.* p. ii.

It is worth noting that in giving evidence to a Senate Committee we were asked to comment on the views put by Glenn Stevens that the big four banks in Australia were no more profitable than other companies included in the top 20 on the Australian stock exchange. That view had been put by the Reserve Bank which claimed that the profitability of the Australian big four banks is 'similar to those of other major companies in Australia…' Their metric was the return on equity of the top 20 ASX companies. That is an interesting list of companies (based on capitalisation 10 November 2010). Top of the list is BHP Billiton and there are five other miners in the top twenty; Rio Tinto, Woodside Petroleum, Newcrest Minerals, Fortescue Mining and Origin Energy. Each of these basically have a monopoly over the deposits they control. Nobody else can compete for the rights to mine in areas controlled by BHP Billiton. Each of the miners receives massive economic rents while commodity prices remain high but are lightly taxed.

After BHP are the four banks themselves, in descending order by market value; the Commonwealth Bank of Australia, Westpac Banking, ANZ Banking Group and the National Australia Bank. Next at number 6 is Rupert Murdoch's News Corp; one of a handful of media companies in Australia which operates in a duopoly with respect to newspapers. Going further down the list of those not already mentioned are:

- Westfarmers which is Australia's largest retailer operating Coles, Bunnings, Target, Kmart, Officeworks and many other activities
- Telstra Corp a telecommunications operator with a near monopoly
- Woolworths which operates in a duopoly market with Coles
- Westfield Group which is unique in operating a chain of shopping centres
- CSL which has a virtual monopoly on blood products
- QBE Insurance has a large regional presence in Queensland
- AXA Asia Pacific together with AMP is one of the two main life offices
- Macquarie Group which is Australia's dominant investment bank and finally,
- Suncorp-Metway, again a relatively minor bank nationally but with a large Queensland presence.

We believe that comparison with the other monopolies, duopolies and oligopolies in the top 20 list simply makes our point that banking is very profitable as are most firms who are lucky to share the market with few others. That in turn is evidence of the exercise of economic power. Further to that *The rise and rise of the big banks* made the point that according to the IMF[17] the Australian big four banks are the most highly concentrated in the world as measured by the share of banking business controlled by the biggest four banks in each country. Interestingly, the country with the second most concentrated banking industry is New Zealand, whose big four banks are owned by Australia's big four banks. Australian banking is much more concentrated than, for example, the US and UK and in addition the IMF has shown that the Australian big four banks are four of the top eight most profitable banks in the world. We are arguably the most ripped off bank customers in the world and should not be proud of that status.

The rise and rise of the big banks also examined the ownership of the big four banks. Table 1 is reproduced from that report.

[17] IMF (2012) 'Australia: Financial system stability report'.

Table 1: Big four banks and their top four owners, 2012 Owners

	ANZ	CBA	NAB	WBC	Average
HSBC Custody Nominees	18.88	14.10	17.25	16.68	16.73
JP Morgan Nominees Australia Limited	15.65	11.13	14.47	13.06	13.58
National Nominees Pty Limited	13.09	8.53	11.25	10.03	10.73
Citicorp Nominees Pty Limited	1.79	4.18	4.91	4.31	3.80
Other top 20 owners	10.27	7.19	7.04	8.74	8.31
All other shareholders	40.32	54.87	45.08	47.18	46.86
Total	100	100	100	100	100

Source: Annual Reports

From the table we can see that HSBC Custody Nominees owns very substantial shares in each of the big four banks and is the biggest shareholder in each case. Indeed, it owns over 15 per cent in three of the big four. Apart from the top four shareholders here, an inspection of the data shows that most of the 'other top 20 owners' are companies with a stake in more than one big bank. On average, over 50 per cent of each big bank is owned by shareholders that are among the top 20 shareholders in all the big banks.

Our interest was raised by an episode reported in the press claiming that the NAB had been pressured into desisting from undercutting its big four rivals. The figures in the table raise significant questions. Given that ownership is concentrated in companies which own more than one bank, what are the attitudes of the owners to genuine competition between the banks? Someone owning shares in all four banks would want them all to do well; the best the banks can do collectively is to form a de facto monopoly through synchronised pricing. In theory a company's management is merely the agent of the owners of the company, so, how is the common ownership reflected in instructions given to management? If two or more listed banks are owned by the same large owners, are common objectives transmitted to the managements of the banks?

The evidence of investor pressure on the NAB to conform with the interest rates charged by the other banks presented in *The rise and rise of the big banks* raises concerns that the concentration of common ownership in the big banks is indeed tempting shareholders to urge those banks to act collectively. The fact that the common ownership of the big banks mainly occurs through nominee companies is significant, because nominee companies are essentially a vehicle for holding shares by some entity or entities which do not wish to be known as the shareholder.

Economies of scale

Money and Power showed that competition has been ineffective in this industry as noted above. One of the features of banking is that economies of scale are important. 'Economies of scale' refers to the case where the unit cost of a 'product' falls as the quantity produced rises. However, economies of scale undermine the notion of perfect competition. As

production costs keep falling as more is produced, a firm that happens to grow bigger will thereby become more competitive.[18]

There are no economies of scale in perfect competition because in the presence of economies of scale whichever company were to grow the quickest would also have a cost advantage and so be able to keep attracting business at the expense of the rest of the firms in the industry. The only stable outcome is one in which there is just one firm remaining in the industry. Competition among a large number of producers can only be guaranteed in the absence of economies of scale so that no producer or small group of producers can dominate a market. However, with greater domination of the market the firm has more market power to extract monopoly profits. An industry with these characteristics represents a clear case of market failure and the need for government intervention.

In one study of Canadian banks by the Bank of Canada the authors found their 'best' model indicated economies of scale that gave a six per cent cost savings by which they meant that a one percent increase in output increased costs by 0.94 per cent[19]. By comparison, if there had been no economies of scale then costs would have increased by the same percentage as the increase in output. If that figure applied in Australia it means a doubling of the size of a bank would reduce its unit costs by around four per cent.[20] Perhaps more importantly, an institution with one per cent of the assets of the smallest of the big four will have a cost structure 32 per cent higher than the smallest of the big four. The ANZ is the smallest of the big four with assets of $361 billion in September[21]. A bank with assets of $3.6 billion would therefore face a cost penalty that virtually wipes out its profit margin. Twenty of Australia's 54 operating banks fall into that category with assets of $3.6 billion or less. In the meantime a bank that catered for the whole market would be expected to have assets over five times bigger than the average of the big four and with a cost advantage of 9.5 per cent compared with the big four.

These figures should not be taken too literally, but they are indicative of the likely orders of magnitude involved. Some smaller institutions may well be able to compensate somewhat by contracting out some of their backroom functions and other activities. They also explain why the big banks are so much more profitable than the smaller banks in Australia. For example, APRA figures show that the profit margin of the big banks was 25.2 per cent in 2010 compared with only 11.9 per cent for the rest of the banks[22]. The important point is that governments face the trade-off between an efficient banking system if there is more consolidation, but at the expense of creating ever more powerful monopolies. Maintaining competition through the four pillars policy might reduce monopoly power but at the expense of a more inefficient system. Even then, as the Australian experience suggests, the main players may exploit their small numbers by acting as a monopoly. In many industries the policy is to allow consolidation but address market power through regulation and government ownership. Most other privately-owned utilities are heavily regulated and usually have a formal price setting process.

[18] We have to admit that economists find it hard to discuss an industry in which it is hard to define the output in a meaningful way and in a way that can be quantified. It is simply hard to define exactly what it is that a bank sells.

[19] Allen J and Ying L (2005) *Efficiency and economies of scale of large Canadian banks*

[20] The earlier report by the Senate Economics Committee included a chart that also showed economies of scale in Australians financial intermediaries. Visual inspection of chart 3.1 suggests that a doubling of the size of institution's assets (going from 4.0 to 5.0 on the assets scale) is consistent with a reduction in unit costs of 75 per cent. That finding is much larger than implied by other estimates (Senate Economics Committee, 2010).

[21] Australian Prudential Regulation Authority (2010) *Statistics Quarterly Bank Performance June 2010*

[22] Australian Prudential Regulation Authority (2010) *Statistics Quarterly Bank Performance June 2010*

A consequence of the global financial crisis is that the smaller banks were temporarily even less competitive against the big banks and that may be a permanent outcome.[23] The technical factors imply that policy makers have few weapons to tackle monopoly profits without structural change. It is important to recall the position of Milton Friedman who noted that in the event of economic power through monopoly 'there is only a choice among three evils: private unregulated monopoly, private monopoly regulated by the state, and government operation.'[24] The evil for Friedman in a private unregulated monopoly is that the community is forced to pay much more than the cost of delivering the service and the monopoly delivers excess profit to someone who is in a position to exercise economic power. In effect this is extortion on the part of the private monopoly operator. Friedman suggested the least bad option was government operation. However, Australia and most of the world have opted for private monopoly regulated by the state.

At the very least the Committee should recognise that it is dealing with a chronically bad system given the system's tendency for monopoly driven by economies of scale.

Deregulation and financial innovation

Paul Volcker, the former head of the US Federal Reserve System, tells the story of meeting a Nobel Prize winning economist who was one of the innovators of financial engineering. When Volcker asked him what financial engineering did he said 'it moves around the rents in the financial system—and besides, it's a lot of intellectual fun'.[25] Volcker now says: 'I have no doubts that it moves around the rents in the financial system, but not only this, as it seems to have vastly increased them'.

The concept of 'rent' is clear to anyone when we are talking about prime central business district office space. In that case a high rent is the money the landlord can demand for favourably located property. Rent also reflects monopoly power to some degree. There is a scarcity of prime land and that scarcity is exploited by one or a small number of owners of the scarce resource. The extraction of rent involves some degree of monopoly power.[26] Telstra is able to earn rents because it owns the only fixed-line telecommunications network. Banks earn rents because they enjoy lower unit costs with greater size but are under no pressure to pass that on to customers. In one way or another rent is the exploitation of monopoly power.

Innovation in the financial market has involved many new ways to extract rents from the rest of the economy and move them around the financial system. The result was that just before the global financial crisis profits of the financial system were as much as 40 per cent of all corporate profits in the US and UK.[27] When finance looms that large as a share of the corporate sector something must be wrong. The Stiglitz commission (UN) suggested 'financial crises are often associated with unsustainable growth of the financial sector'.[28] The growing literature on 'financialization' has been spawned by the concern about the growth in finance relative to the rest of the economic system in global financial centres. The Warwick

[23] This was pointed out in Richardson (2010)

[24] Friedman M (1962) *Capitalism and Freedom*, Chicago University Press.

[25] Murray A (2009) 'Paul Volcker: Think more boldly', *The Wall Street Journal*, 9 December.

[26] Economists talk about 'economic rent' being the surplus over and above the returns that would justify remaining in the industry.

[27] Woolley P (2010) 'Why are financial markets so inefficient and exploitative – and a suggested remedy', A Turner and others, *The Future of Finance: The LSE Report,* London School of Economics and Political Science, pp.121-143.

[28] Commission of Experts of the President of the United Nations General Assembly on Reforms of the International Monetary and Financial System (2009) p47

Commission on International Financial Reform made the point that ‘finance, like law and accounting, should be about facilitating economic investment, not being the investment’.[29] Recent studies have shown a negative correlation between the size of the financial sector and GDP growth[30] which suggests that countries should seek lean financial systems rather than the financialization model.

The role of the finance sector should be to channel funds efficiently from savers to borrowers, the smaller the profile of the finance sector the more efficiently it is doing its job. Indeed, in *A licence to print money* we made the point that high banking profitability increases the ‘wedge’ between borrowing and lending rates and so imparts a serious imperfection into the allocation of resources over time.[31] By contrast over recent decades we have seen massive growth in all sorts of financial engineering and the development of derivatives and other products that were unimaginable 40 years ago. In Australia the assets of authorised deposit-taking institutions at the end of June 2013 were 210 per cent of GDP that year and for the financial sector as a whole assets were 356 per cent of GDP.[32] By comparison the off-balance sheet business of the banks was a massive 1521 per cent of GDP. These figures are worth bearing in mind in the context of the too-big-to-fail argument.

It became apparent in the aftermath of the global financial crisis that most people who bought the complex products did not know what they were really buying and those that did had off-loaded them or packaged them up and sold them to subsequent buyers who would have had much less information about the nature of the loans. The asymmetric knowledge of the buyers and sellers has meant there is a massive incentive to mislead buyers and disguise toxic assets as top-rated securities—which is exactly what led up to the global financial crisis in the first place. Where there is asymmetric knowledge there is an incentive to exploit it on the part of the party with the greater knowledge.[33] That is why some of the bankers and economists have blamed the global financial crisis on a failure in the regulatory regime. The bankers’ complaint has been wittingly paraphrased as saying ‘It’s your fault: you let us do it!’[34] that seems to confirm the views of McCarty et al (2013) cited above to the effect that many in the industry are liable to flirt with the law if not break it and need to be controlled. Certainly the Stiglitz UN Committee has been scathing and essentially blames free market ideology. It is worth quoting in full:

> *…Both policies and economic theories played a role. Flawed policies helped create the crisis and helped accelerate the contagion of the crisis from the country of its origin around the world.*
>
> *3. But underlying many of these mistakes, in both the public and private sectors, were the economic philosophies that have prevailed for the past quarter century (sometimes referred to as neoliberalism or market fundamentalism). These flawed theories distorted decisions in both the private and public sector, leading to the*

[29] Warwick Commission on International Financial Reform (2009) *in praise of unlevel playing fields*.

[30] Notermans T (2013) ‘Reforming finance: A literature review’*, Financialisation, economy, society and sustainable development, No 8 working paper series.*

[31] In principle a narrowing of the gap between borrowing and lending rates makes possible new lending that enables new borrowing for productive uses to the benefit of both savers and investors.

[32] Figures based on RBA (2014) Statistical tables

[33] Admittedly banks are sometimes on the other side of the asymmetry when, for example, someone seeks a loan for a project they may know all about but the banks have no way to assess its commercial potential. Those sorts of considerations are behind calls for specialist financing when general lenders can not be expected to understand and evaluate the risk of a project. To protect themselves against their own ‘ignorance’ lenders will usually want to lend against security.

[34] Stewart cited in Morgan J and Sheehan B (2014) Information economics as mainstream economics and the limits of reform: what does the Stiglitz Report and its aftermath tell us? *Real-world economics review*, Issue no 66, pp. 95-108.

policies that contributed so much to the crisis and to the notion, for instance, that markets are self-correcting and that regulation is accordingly unnecessary. These theories also contributed to flawed policies on the part of Central Banks.

4. Flawed institutions and institutional arrangements at both the national and international level also contributed to the crisis. Deficiencies in international institutions, their governance, and the economic philosophies and models on which they relied contributed to their failure to prevent the crisis from erupting, to detect the problems which gave rise to the crisis and issue adequate early warning, and to deal adequately with the crisis once it could no longer be ignored. Indeed, some of the policies that they pushed played a role both in the creation of the crisis and its rapid spread around the world. All of this facilitated the export of toxic products, flawed regulatory philosophies, and deficient institutional practices from countries claiming to be exemplars for others to follow.[35]

The present terms of reference mention financial innovation. Volker once made the famous quip that the only worthwhile innovation in the financial system over many decades was the automatic teller machine. Putting his comments in context he said:

I hear about these wonderful innovations in the financial markets and they sure as hell need a lot of innovation. I can tell you of two — Credit Default Swaps and CDOs — which took us right to the brink of disaster: were they wonderful innovations that we want to create more of?

I mean wake up, gentlemen — I can only say that your response is inadequate. I wish that somebody would give me some shred of neutral evidence about the relationship between financial innovation recently and the growth of the economy, just one shred of information.

The most important financial innovation that I have seen the past 20 years is the automatic teller machine, that really helps people and prevents visits to the bank and it is a real convenience. How many other innovations can you tell me of that have been as important to the individual as the automatic teller machine, which is more of a mechanical innovation than a financial one?

I have found very little evidence that vast amounts of innovation in financial markets in recent years has had a visible effect on the productivity of the economy… All I know is that the economy was rising very nicely in the 1950s and 1960s without all of these innovations. Indeed, it was quite good in the 1980s without Credit Default Swaps or CDOs. I do not know if something happened that suddenly made these innovations essential for growth. In fact, we had greater speed of growth in the 1960s and more importantly it did not put the whole economy at risk of collapse.[36]

Since Volker has compared the earlier post war decades with more recent decades it raises the question of what the Australian data look like. Such a comparison was done to examine the proposition that cutting corporate and top marginal rates would boost economic performance.[37] However, roughly the same timing was involved in the gradual deregulation of the finance sector. Moreover the present terms of reference invite comment on the tax

[35] Commission of Experts of the President of the United Nations General Assembly on Reforms of the International Monetary and Financial System (2009) *Report*, NY: United Nations

[36] Smith A (2009) 'the only thing useful banks have invented in 20 years is the ATM', *New York Post*, 13 December.

[37] Richardson D (2014) 'the taxation of capital in Australia: Should it be lower?' In Schroeder SK and Chester L (Eds) *Challenging the orthodoxy: Reflections on Frank Stilwell's contribution to political economy*, Springer, pp 181-202.

rates so it is worth repeating the findings here. Since 2001 with a 30 per cent company tax rate the unemployment rate averaged 5.2 per cent however, between 1950 and 1987 when the company tax rate was 45 to 49 per cent the unemployment averaged 3.3 per cent.

Investment and other economic variables have hardly improved. Between 1960 and 1987 investment in the private sector averaged 20.7 per cent of GDP compared with 22.1 per cent in the period since 2001 and the privatisations and the mining boom more than account for that small increase. Again real economic growth was 3.8 per cent between 1960 and 1987 but only 3.1 per cent since 2001. Apparently Australia performed better with higher company tax rates and more regulation! Of course the top marginal rate also came down in these periods while dividend imputation was introduced. It might be objected that there were many other things happening. While that is true it means that if there were any benefits from deregulation and lower company tax rates they were not strong enough to be apparent in the Australian economic performance.

Volker in the comments cited above also made the point that none of the boards of the firms using financial innovations are likely to understand them and that imposes huge problems for governance in the corporations operating in the financial sector. In that regard it is also worth mentioning that there is already cause for concern with rogue traders using sophisticated instruments and we recall the problems imposed by staff members that brought down Barings Bank and caused concern for the National Australia Bank.

There has been a proposal that new financial products should require authorisation by the regulators before they can be sold.[38] They would be treated much like new pharmaceuticals and have to show that they are useful as well as safe for both the buyers and for the stability of the financial system as a whole.

In the introduction we mentioned the prospect of crony capitalism appearing in the Australian context. Following the global financial crisis we noticed that both the Reserve Bank and the Australian Bankers Association appeared to be giving the same message when they introduced concepts of ‘effective’ and ‘safe’ levels of competition. The argument is that the more intense competition, the more risky bank behaviour is and so the more precarious the banking system. Hence, there is now talk of a trade-off between competition and the stability of the banking system.[39]

This notion raises more questions than it answers. There is no evidence that small deposit-taking institutions at the fringe of the Australian market have any more inclination to take on excessive risk than the big uncompetitive banks. Nor is there any evidence that the incentive structure is different in the more competitive part of the industry which might cause the greater willingness to incur risk in that part of the industry. But we do know that there is a strong incentive for incumbent firms to want to stifle competition including through non-market means.

We think the thesis of a trade-off between stability and competition is a furphy if not a self-serving delusion. However, the link between deregulation and instability is clearer. It is worth quoting a more recent contribution by Stiglitz who claims that ‘making markets more flexible may exacerbate the disequiibrating [sic] dynamics’. Moreover:

[38] Notermans (2013) *Reforming finance: A literature review*, op cit.7

[39] In the case of the Reserve Bank see the evidence by Glenn Stevens in Senate Economics Reference Committee (2010) *Hansard transcript of evidence: Competition within the Australian banking sector*, 13 December. For the bankers' view see Münchenberg, S (2011). ‘Balancing bank stability and competition’, *The Australian*, 17 January.

> *Many of the other so-called market reforms have both exposed countries to more shocks and weakened the automatic stabilizers—capital and financial market liberalization and tarrification have enhanced the potential for external shocks to disturb domestic markets; and the move from defined benefit to defined contribution pension programs, the greater reliance on capital adequacy standards, rigidly enforced, and on simplistic rules, like balanced budget frameworks for governments, have weakened automatic stabilizers and sometimes replaced them with automatic destabilizers.*
>
> *Regimes for exchange rate adjustments reflect an ongoing debate on the relationship between market flexibility and dynamic stability. The hope was that moving to flexible exchange rates would enable adjustments to occur smoothly, so there would be no crisis. What has happened in the forty years since the abandonment of the fixed exchange rate system (especially the last thirty years) has shown that that hope was misplaced. There continue to be crises, marked by sudden changes in exchange rates and/or changes in prices in financial markets with concomitant large changes in the level of economic activity.*[40]

Another furphy the banks like to promote is that we all benefit through high bank profits mainly through our indirect shareholding via super funds. *Money and power: The case for better regulation of banking* showed that indeed, many workers hold shares in banks indirectly through superannuation, and therefore arguably receive a share of their profits. Yet the distribution of share ownership and superannuation balances means that the wealthiest Australians capture most of the benefits flowing from bank profits. In other important respects the behaviour of the banks runs counter to the interests of the broader community.

It is also worth pointing out that while the bankers may think they share their monopoly profits with the retail investor the latter do not really benefit because purchases on the stock exchange already have monopoly profit capitalised into the share price. Indeed, the problem now is that any attempt to address the monopoly profit would run into opposition from those who would see a fall in the value of their shares. That is not an argument against addressing monopoly profit; just an anticipation of the strength of the opposition.

A licence to print money made the point that the failure of competition policies over a century and half suggests competition alone is never going to work, although it may well be an important part of any package. We are attracted to the views of the former Governor of the Bank of England, Mervyn King, who observed 'Of all the many ways of organising banking, the worst is the one we have today' and moreover 'ever since the Industrial Revolution we have not cracked the problem of how to ensure a more stable banking system'.[41] We now turn to consider his views.

Structural separation

There is another possible form of competition based on structural separation of the banking business. We note that Australian banks are prohibited under the Banking Act from applying depositors' funds for purposes other than strictly traditional forms of bank lending. Banks are certainly not allowed to apply depositors' funds to such things as purchases in the share market. That prohibition had been lifted in the US and elsewhere and the global financial crisis was one of the consequences. Following the global financial crisis governments in

[40] Stiglitz J (2012) 'Crises: Principles and policies with an application to the Eurozone crisis' Paper presented to International Economic Association Roundtable on "Debt Crises – How to prevent them, how manage them, how to ensure there is life after debt" Buenos Aires, August 13-14.

[41] King M (2010) 'Banking: From Bagehot to Basel, and back again', The Second Bagehot lecture, Buttonwood Gathering New York.

other countries have been trying to return to a segregation of traditional and investment banking.

We should congratulate ourselves that we avoided making the same mistaken deregulation. However, it has to be appreciated that the traditional model allows banks to monopolise the mobilisation of funds through the payments system and then to dominate the lending market. The Australian banking system is, as pointed out earlier, dominated by the four big banks which, through their access to the clearing system, have monopolised the payments system. This gives them an abundant source of cheap money and places them in an ideal position to monopolise the nation's lending behaviour. King's concern mentioned above was more about the regulatory problems inherent in banking and the propensity for banks to use other people's money to invest in risky undertakings. For him the issue was that the 'damaging externalities created by excessive maturity transformation and risk-taking must be internalised.'

But King also raises the possibility of divorcing the payment system from the rest of the financial sector:

> *if banks undertake risky activities then it is highly dangerous to allow such "gambling" to take place on the same balance sheet as is used to support the payments system, and other crucial parts of the financial infrastructure.*[42]

For King the issue is that 'Banks [lending] should be financed much more heavily by equity rather than short-term debt'.[43] Others have made similar proposals, for example Professor John Kay, supernumerary fellow economics at Oxford University, refers to the need for 'the separation of utility from casino banking.'[44] The utility part refers to the payments system which should be considered a utility on a par with electricity, post, transport services and the like.

King also compares banking with the electricity sector. The essential feature of both finance and electricity is a system which links the initially mismatched demands of suppliers and customers in real time. In both industries, there is a choice between two broad structures, hierarchy or markets. Coordination can be achieved by a single integrated organisation – which in practice must be publicly owned or behave as if it were a public agency rather than a private business. Or coordination can be accomplished through a competitive market place, with a core monopoly utility – the grid, the payment system –tightly regulated on price, service quality, and access.

In a free market, narrow banking could have emerged spontaneously since depositors would strongly favour conservative, transparent institutions which eschew complex financial instruments and demonstrate comprehensible balance sheets and organisational structures. Recent history is likely to have caused people more concern for the stability of their money – or would have in the absence of strong government involvement. But of course government regulation has pre-empted that sort of consumer reaction. In a sense government intervention has distorted the market.[45] All savers enjoy equal deposit protection, however

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[42] King M (2010) 'Banking: From Bagehot to Basel, and back again', The Second Bagehot lecture, Buttonwood Gathering New York, 25 October, p. 18, available at
http://www.bankofengland.co.uk/publications/speeches/2010/speech455.pdf

[43] King p 18.

[44] Kay J (2009) 'Narrow Banking: The reform of banking regulation' Centre for the Study of Financial Innovation.

[45] It is likely that some of the residual concern about the safety of depositors money has caused a shift further away from non-bank institutions following the global financial crisis. The big banks are seen as more stable. We also suspect there is a perverse concern to have mortgages with a solid institution. Perverse because if the

risky the activities of the institution with which they save. Those who save with large financial conglomerates enjoy the further reassurance that comes from frequent reiteration of the slogan that these businesses are 'too big too fail'. The outcome of market forces has been suppressed, and the natural outcome of market forces – narrow banking - should be imposed by regulation.

Structural separation would have benefits for the stability of the financial system, however, it should also address the problems of a small group of banks monopolising the payments system. As a utility, the clearance and electronic networks that make the payment system work should be regulated in the public interest. The more transactions that migrate to electronic forms the cheaper the payments system will be to operate. In principle, the marginal cost of making an electronic payment is already zero. The difference between the marginal and average cost points to a large market imperfection.

A possible model would involve;

1. A sound group of institutions engaged in deposit-accepting with access to the transfer and clearing system and able to accept all types of long and short deposits.
2. A supervised group of commercial institutions engaged in retail lending able to borrow from the deposit-accepting institutions and subject to similar prudential supervision as applies to lenders at the moment. Loans to big business would need to be secured.
3. Other lenders, investment funds, wholesale lenders etc, who would not be permitted to raise funds through deposits but could issue bonds and equity and are fairly free to make any loans or investments they wish. The main restriction would be that they cannot apply any short term debt towards long term loans and investments.

It would be unlawful to raise deposits outside this framework, however, other lenders would be free to use their own funds, or equity like funds to apply against their other lending activities. Indeed, for John Kay, the rest of the banking system could be further deregulated, safe in the knowledge that they are not putting depositors' funds at risk. However, it is unlikely that the rest of the financial system could realistically be deregulated, but the regulation would be different to that applying to the deposit acceptors and retail lenders. Note that the failure of Long Term Capital Assets lead to the bailout and subsequent re-regulation of the hedge funds. It is not clear that any large financial institution should ever be completely deregulated.

King points out that the attraction of the more radical solutions is that they offer the hope of avoiding the seemingly inevitable drift to ever more complex and costly regulation. However, we believe that retail lending would be more competitive if all lenders had the same access to the pool of funds generated through the deposit-acceptors. The OECD argued that lending for small and medium-sized firms tends to remain local rather than centralised.[46] By contrast the payments system relies on one network which operates the transfer and clearing functions. At present that network is operated by the member institutions and regulated by the Reserve Bank of Australia through the Payments System Board. There is no reason to change this arrangement, but existing institutions would have to decide whether they would become retail lenders or deposit acceptors able to provide retail access to the payments system.

There is a lot of detail that would need to be fleshed out to offer a fully workable system. However, it seems very important that we seize the present mood about banking and raise

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mortgage provider fails the worst that can happen is that the mortgage is offloaded to another creditor but there is always the prospect that no-one is left as the creditor!

[46] OECD (2009) *Competition and Financial Markets*

more radical options in the public debate and in the context of 'this root and branch review of the nation's financial system'.[47] The detail can be worked out later.

In the meantime *Money and Power* suggested the aim of policy should be to reduce bank profits to one per cent or less as a share of GDP, the level they were at two decades ago. Other policy changes that would contribute to this aim include:

- Legislating to ensure that interest rates charged by banks move in line with changes to the RBA cash rate and are set and advertised as a mark-up over the cash rate.
- Establishing a separate licensing regime for financial institutions that provide payment services and infrastructure to retailers, thus encouraging new entrants into this market.
- Capping certain kinds of bank fees at a level sufficient to cover costs, including a reasonable return on assets.
- Mandating that all financial institutions offer a no-frills, low-cost everyday savings/transaction account to every customer.
- Restricting the interest rates that can be charged on unsecured credit to levels that reflect the underlying risk to the lender.

Such initiatives would help bring profits back to a reasonable level, but it is also important that banks do not use their privileged position to exploit the vulnerabilities of individual customers. Something more is needed to ensure that banks behave in socially responsible ways that contribute to the wellbeing of the broader community. In the absence of Friedman's third option, government operation, this sort of regulation is essential so as to avoid the first option, the private unregulated monopoly. We turn to consumer issues below.

The use of emotional techniques in advertising and marketing financial products is common and clearly effective. However, marketing that relies solely on such techniques without providing any helpful information or guidance to consumers is misleading and manipulative, prompting widespread public mistrust of banks. Banks should promote their products in ways that contribute to, rather than undermine, broader public understanding of financial concepts and imperatives. If they choose not to do this, it is the responsibility of government to monitor and regulate their communication with customers, particularly in the marketing of credit. This can be achieved in various ways:

- Establishing national laws to ensure that credit is not extended to people who do not have the capacity to repay
- Preventing banks and debt collectors from pursuing debts for loans made to people who did not have the capacity to repay when the money was originally loaned
- Restricting or banning sales targets and commissions for bank workers
- Providing bank workers with a decent ordinary wage independent of sales-based commissions
- Banning the practice of 'pre-approving' credit-card offers and/or credit extensions
- Preventing banks from claiming money spent on the advertising of credit products as tax deductible business expenses.

These reforms could constitute part of a formal social contract between individual banks and government; ratifying the social contract would then become a condition of maintaining a banking licence. Without this kind of policy intervention, the profits of the big banks will only get bigger.

[47] Hockey J (2013) 'Financial system inquiry' *Media Release*, 20 December.

Superannuation

The Australia Institute has written extensively on the subject of superannuation. In May 2008 we published *Choice Overload: Australians coping with financial decisions*. That paper documented the limited information super members have and the lack of engagement with their funds. The implication is that people did not have either the financial literacy or interest to make rational decisions. Hence they were unlikely to do well out of the earlier policy of offering greater choice to consumers.

Choice overload was followed by *Choosing not to choose: Making superannuation work by default* in November 2008. That developed the critique of the Choice of Fund policy for failing to protect those consumers who were disengaged from superannuation issues while generating additional income for fund managers and financial planners. This paper also argued strongly for a default super system, a policy that was elaborated upon in *The case for a universal default superannuation fund* in September 2009. Those arguments were ultimately reflected in the Cooper Review[48] and subsequently in new superannuation arrangements.

Can the taxpayer afford self-funded retirement? examined the tax expenditures that are spent on subsidies for superannuation with the bulk of those subsidies going to the very rich. Self-managed super funds (SMSFs) are now firmly entrenched as the vehicle of choice for tax avoidance by high income earners and high wealth individuals. At June 2013 a total of 509,362 SMSFs had total assets of $506 billion[49]; the average assets of SMSFs was $993,000 while tax office figures[50] show their average income was $86,000 in the 2010-11 financial year. Ten SMSFs had reportable income of $5 million or more. The extreme bias in super tax concessions towards high income earners was addressed in *Super for some: Who wins and loses from $30 billion worth of tax concessions for superannuation?*

There is a strong gender bias in the superannuation system with males able to accumulate much higher balances and subsequently receive much higher payouts compared with the experience of women in Australia. Essentially men get the money but women have the higher 'survival risk' as the actuaries put it. The issue was addressed in *What's choice got to do with it?* in August 2013.

Aspects of the governance of superannuation were addressed in *Time to get engaged with super?* which found that many members thought their funds should take greater account of ethical and environmental considerations in managing their investments.

Insurance

Australia has witnessed a large number of cooperative insurers (and other cooperatives) demutualise and morph into privately owned corporations. Among those have been big insurers such as NRMA Insurance (now IAG) which dominates the Sydney market. That period of demutualisation seemed to be motivated by the managements who wanted the private sector CEO incomes and the owners/members who were given the one-off capitalised value of the benefits of being members.

It is important to ask if that has had an impact on the prices paid by consumers. An attempt to answer that is given in Figure 1.

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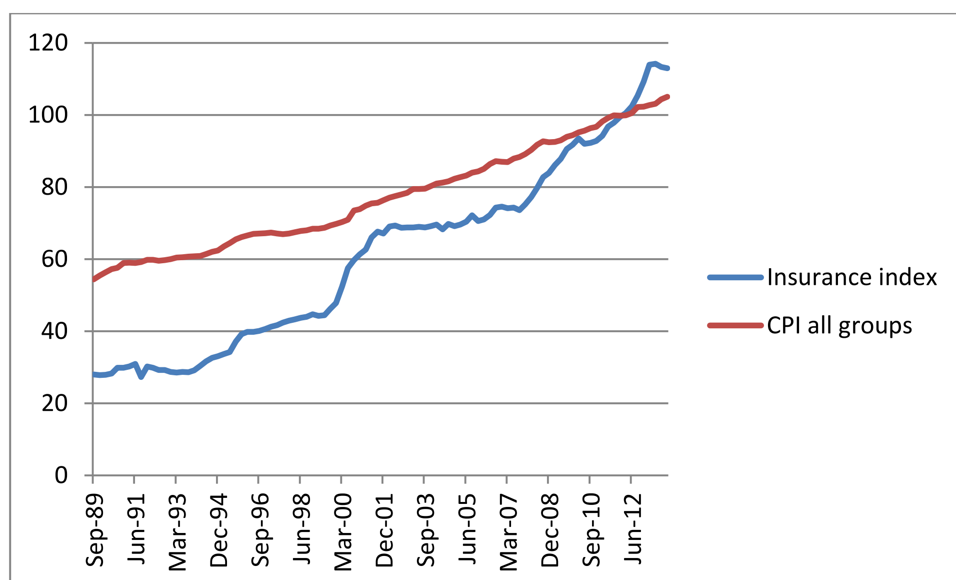
[48] Review of the Governance, Efficiency, Structure and Operation of Australia's Superannuation System (2010)

[49] APRA (2014) *Statistics: Annual Superannuation Bulletin, June 2013*, 8 January.

[50] Australian Taxation Office (2013) *Taxation Statistics, 2010-11*, 24 April.

Figure 1: Sydney CPI: Insurance index and the all groups index



Source: ABS (2014) *Consumer price index, Australia, Dec 2013*, Cat no 6401.0, 22 January.

NRMA was demutualised in August 2000 but the intention was announced in February subject to member approval in April. As it happens that was associated with the largest increase in Sydney insurance prices since data have been kept by the ABS (September 1989) as can be seen on the graph. From December 1999, just before the demutualisation announcement, through to December 2001 insurance prices increased 40 per cent. The rest of the Sydney CPI increased just 9.5 per cent over the same time.[51] The introduction of the GST complicated things at the time, because the price of insurance services in the CPI are estimated basically by taking gross premiums and deducting the value of claims. So the insurance group might be expected to increase by more than the impact on gross premiums. However, the increase of 40 per cent in Sydney from Dec 1999 to Dec 2001 was much higher than the Melbourne, Brisbane, Adelaide and Perth increases in the same period with the latter experiencing increases of 29, 34, 25 and 29 per cent respectively.[52]

It is hard to believe that a large part of the increase in Sydney relative to the other mainland capitals was not due to the demutualisation of the NRMA which, to that point would have served the purpose of keeping down the prices of other insurance providers to the level that a mutual needed.

APRA figures also show a very healthy after-tax return on net assets of around 16 per cent in the insurance industry.[53] The general insurance area also seems very profitable when general insurers in Australia charge premiums of 167 per cent of the value of the claims they meet based on the most recent figures for the four quarters ended September 2013.[54] When consumers are asked to pay almost twice the expected value of any insurable losses it seems something is seriously wrong. There is a strong public interest in the encouragement of insurance so that the rest of us are protected from those who do not insure. However, it seems unreasonable to expect people to insure when they are faced with a very ‘unfair bet’ as a gambler might put it.

[51] The all groups increase at 9.5 per cent may seem large but it will be recalled that the GST was introduced in this period.

[52] Figures come from ABS (2014) *Consumer price index, Australia, Dec 2013*, Cat no 6401.0, 22 January.

[53] APRA (2013) *Statistics: Quarterly General Insurance Performance, September 2013*, 28 November.

[54] APRA (2013) *Statistics: Quarterly general insurance performance, September 2013*.

The overall impression is that the insurance industry is a lucrative industry with considerable scope for increasing efficiency and reducing insurance costs to both consumers and industry. This industry spends a lot on advertising and other promotion. The Australia Institute has drawn attention to other industries in which imperfect competition fosters socially wasteful practices so that consumers pay for costly sales efforts which have little or no impact on the total footprint of the industry.[55]

There seems to be an important role for mutuals and other not-for-profits in the delivery of insurance services and the committee should think about their role, how they might be encouraged and how future demutualisations might be discouraged. Indeed, the government should see it as part of its role to foster a wide choice of financial institutions including preserving the option for consumers to take advantage of not-for-profits. While insurance seems to be the main financial industry where those considerations apply it should also be remembered that there are a large number of member-owned banks, credit unions and building societies that provide important alternatives for consumers. Likewise many super funds are cooperatives.[56]

Cooperatives

Eight in every ten Australians are a member of a co-operatively owned, or mutually owned enterprise (co-ops and mutuals) such as a road side assistance organization (NRMA, RACV), a member-owned superannuation fund (AustralianSuper), a mutually owned bank (such as bankmecu) or a consumer cooperative (Co-op Bookshop). Similarly, large businesses such as the dairy co-operative Murray Goulburn or the giant grain handling enterprise Co-operative Bulk Handling are collectively owned by the farmers who supply them.

A defining feature of co-operatives is their democratic nature. They are owned and controlled by their members, and they apply co-operative principles and values in their day-to-day activities. The combination of a high degree of community participation in co-ops, a low level of public awareness of their own participation, and the ongoing willingness of millions of customers to spend billions of dollars paying higher prices than necessary for goods and services creates a substantial opportunity for both the co-op sector and policy makers to reduce the cost of living for most Australians.

Despite the widespread membership of co-ops, and the size and economic significance of the sector, community awareness of the sector runs far behind community reliance on the sector. Indeed, according to a survey conducted by The Australia Institute, despite the fact that 79 per cent of people are members of a co-op only three in ten Australians could name a co-operative or mutually owned enterprise and only 16 per cent of Australians believe that they are a member of one.

The widespread community reliance on co-ops and mutual organisations suggests that these enterprises have significant advantages over their for-profit rivals. In relation to home mortgages, for example, members of mutually owned banks, credit unions and building societies are estimated to save an average of 0.4 per cent on their mortgage interest rate which, for an average loan, generates savings of $76,417 over the life of the loan and reduces the repayment period by three years. The vast majority of Australians believe that privately owned for-profit companies are more interested in shareholder profit than

[55] See Richardson D (2013) Electricity and privatisation: What happened to those promises? Technical brief no 22, April.

[56] On the importance of cooperatives in the Australian economy see Denniss R and Baker D (2012) who knew Australians were so co-operative? The size and scope of mutually owned co-ops in Australia, October.

customers (90 per cent), that large shareholders have too much influence (88 per cent) and that corporate executives are overpaid (92 per cent).

However, despite these beliefs most Australians do not seek out co-operatively or mutually owned alternatives. For example, as discussed above, even when substantial financial savings are available many Australians do not switch from the 'big four' banks to their mutually owned competitors. In recent years many for-profit companies in Australia have begun to emphasise the contribution that they make to Australian communities. Mining companies and the big four banks, for example, extensively promote any contributions they make to communities even though such contributions represent a very small proportion of total profit.

That said, the willingness of for-profit companies to spend large amounts of money on advertising suggests that the community as a whole is likely to value and admire such contributions. Co-operatively and mutually owned enterprises on the other hand typically invest the surplus they generate into the community or return it to their members. As such, these organisations spend far less money advertising the contribution they make to the community and therefore there is far lower awareness of this contribution.

Of course, the relative lack of expenditure on advertising means that the cost of providing services to members is significantly lower. The big four banks spent more than $1 billion on advertising in 2011, all of which was in turn passed on to their customers through higher interest rates and fees. Ironically, the lower level of expenditure on advertising by co-ops and mutuals means that many members, and potential members, are unaware of the low prices and high quality services that are often available. The relatively high level of consumer satisfaction with co-operatively and mutually owned enterprises and relatively high levels of consumer loyalty, do however, combine to create a circumstance in which such organisations can promote the advantages, to consumers and the community, of their ownership structures without having to match the expense incurred by their privately owned competitors.

These opportunities include the following:

1) Better explain their ownership structure, and its benefits, to their existing customers.
2) Better explain the contribution that mutuals and co-ops make to the community. The mutual sector could highlight its contribution to society by creating a central registry of community support. Similarly, the mutual sector needs to measure, and promote, its contribution to the building of social capital which, in addition to the economic contribution described above, contributes to community wellbeing and resilience.
3) Government ministers and government departments should pay greater attention to the benefits to consumers and communities that flow from co-operatives. They should also do more to overcome the pragmatic or psychological barriers that prevent consumers switching to mutually owned enterprises.

The fact that so many Australians are members of co-ops and mutuals yet so few are aware of this fact is both a challenge and an opportunity for the sector. While it is unclear why so few members are aware of their membership, the fact that they remain members suggests that the quality and price of the service alone is sufficient to retain their custom. If the mutual and co-op sector can succeed in explaining the broader benefits of membership then it is likely that not only will their existing members become even more supportive, but that they will more readily consider a wider range of mutual and co-operatively provided goods and services.

As discussed above, the majority of Australians believe that shareholder-owned companies are too focused on profit and not concerned enough with their customers. Similarly, since the recent meltdown of the financial system during the Global Financial Crisis many Australians have expressed their desire for change and the development of 'an alternative'. Paradoxically, many of those people who express a desire for something new are likely to be members of at least one such alternative. In the interests of fostering competition in the financial and other sectors government could well look at measures to improve the public awareness of cooperatives as a viable alternative to for-profit institutions.

Share market and corporate governance

In the discussion on banking we raised the question of the common ownership of banks and the serious questions this raises about the independence of different companies operating in the same market. We have serious rules about matters such as collusion among companies but we have not had a debate about the role of common owners of these companies. The problem is widespread.

In *Corporate power in Australia* we also showed that Woolworths and Westfarmers (which owns Coles) are owned by the same shareholders.[57] We extracted the top 20 shareholders of each company to find out how much of each company is owned by top shareholders that are common to both companies. The results are presented in Table 2. Note that occasionally annual reports attribute ownership to two or more entities if those entities hold their shares in two or more accounts. In Table 2 those are collapsed into one entity. Hence the number of owning entities is less than 20 in the table.

[57] Richardson D (2013) ‘Corporate power in Australia’, *Paper given to 12th Australian Society of Heterodox Economists Conference*, University of New South Wales, 2-3 December.

Table 2: Top shareholders in Woolworths and Westfarmers (Coles)

Owners	Woollies	Wesfarmers	Unweighted average
JP Morgan Nominees Australia Limited	12.3	16.0	14.2
HSBC Custody Nominees	16.6	7.7	12.2
National Nominees Pty Limited	10.0	12.5	11.3
Citicorp Nominees Pty Limited	4.0	2.4	3.2
BNP Paribas Noms Pty Ltd	2.4	1.0	1.7
AMP Life Limited	0.7	1.9	1.3
MF Custodians Limited		2.3	1.2
Australian Foundation Investment Company Limited	0.5	0.9	0.7
RBC investor services Australia Nominees Pty Limited	0.2	1.2	0.7
UBS Nominees Pty Ltd	0.4	0.9	0.7
Buttonwood Nominees Pty Ltd		0.8	0.4
Mr Peter Alexander Brown		0.5	0.3
Credit Suisse Securities (Europe) Ltd		0.5	0.3
Argo Investments Limited	0.3		0.2
Australian Executor Trustees Limited		0.3	0.2
Milton Corporation Limited	0.2		0.1
Navigator Australia Ltd	0.2		0.1
Perpetual Trustee Company Limited	0.2		0.1
QIC Limited	0.2		0.1
Questor Financial Services Limited	0.2		0.1
Total	48.5	48.9	48.7
Common owners	47.1	44.5	45.8
% Ownership of common owners as share of top 20 owners	97.1	91.1	94.1

Source: 2012 annual reports

The results are very important. The owning entities included in Table 2 own almost half of the two companies: 47.1 per cent of Woolworths and 44.5 per cent of Westfarmers. Weighted by value of the shareholding the table implies that 97.1 per cent of the top 20 shareholders in Woolworths also own Westfarmers and 91.1 per cent of Westfarmers top 20 shareholders also own Woolworths. These figures are disturbing as, like in banking, they suggest a high degree of interdependence. Two big retailers is bad enough but given their common ownership it is not clear they are in fact independent.

Implications of common ownership

If anyone can be thought of as exercising control of a company it is the owners and especially the biggest owners. The management of a company is supposed to be a mere agent of the company and is supposed to act in the best interests of the shareholders. However, if the management knows that the owners also own the competing companies then management knows that vigorous competition can hurt the owners. It also has to be considered from the owners' perspective. The owners of two or more industry players do not

want to see genuine competition break out. Obviously there are rules against collusion, but it is doubtful the rules can stop a common owner if that owner conveys messages to two or more managements that has the effect of lessening competition.

Given that ownership is concentrated in bodies that own both companies, the same question arise as those that arise in the case of the big four banks. Someone owning shares in both companies would want them all to do well and the best they can do collectively is to form a de facto monopoly through collusion.

It is very possible that low productivity and other features of the Australian retail industry are heavily shaped by the monopoly structures in Australia that are reinforced by a common ownership.

These questions are awkward in a country like Australia which tends to be dominated by a concentrated industry structure. Mining, banking, telecommunications, insurance, transport and other Australian industries appear very concentrated compared with the rest of the world. And of course they can be even more concentrated if they are owned by common owners. We cannot go into the details of all of those industries but the macro figures and the banking and retail case studies suffice to give evidence of a highly concentrated economy as shown in *Corporate power in Australia*.

The Inquiry would do well to further examine the implications of the concentration of business in many Australian industries as well as the common ownership of companies.

International aspects of the financial system

Australia is interested in the international aspects of the financial system because of the impact that ripples in the rest of the world have on Australia and because Australian financial corporations have often expressed interest in generating more business offshore. We take up both of those themes in this section.

The international non-system

Since the breakdown of Bretton Woods in the early 1970s the world monetary system has been characterised by a system of floating exchange rates between major currencies, albeit with many minor currencies maintaining fixed rates with one of the major currencies and some being fixed to a basket of currencies. A system of flexible and market-determined exchange rates was advocated by people such as Milton Friedman who argued that the system would be stable. Speculation that took place in the 1930s was betting against countries being able to maintain fixed rates. However, speculation in a ‘free’ market would involve traders taking a position when they thought currencies had departed from their fundamental values and so speculation would involve moving us back towards a stable set of international exchange rates. Of course things have not worked out that way at all and the number and severity of international exchange rate crises has increased. The world looks much less stable now than before Bretton Woods.

The other main characteristic has been the use of the US dollar as the major international reserve asset and means of international payment. The use of a national currency as the international currency (whether the US$ now or pound sterling in years gone by) has created a host of problems. Not least of those are the benefits of seigniorage for the country that issues the reserve currency and the easy borrowing terms and conditions since all surplus countries want to hold the bulk of their reserves in assets denominated in the reserve currency.

As illustrated by the UN Commission of Experts chaired by Joseph Stiglitz [58] the present system has imparted instability and a deflationary bias into the world economy. Increases in global liquidity can only come about from US deficits but they in turn erode confidence in the value of the US$. The Treasurer was recently asked whether the US should take more account of the complaints of developing economies that the US and other developed economies are not mindful enough of the impact of their moves. He said 'I think the US is listening and it does understand the pressures on a number of different economies.…But ultimately the US Federal Reserve's primary responsibility is to the people of the United States and they have to put the US economy first'.[59] That of course is precisely Stiglitz's point; the US does not have a mandate to monitor, regulate and control the global economy and neither does anyone else.

Meanwhile, attempts by the US to reduce its current account deficit tend to produce deficits in other countries so long as surplus countries continue to maintain their surpluses and the sum of all deficits equals the sum of all surpluses.

Deficits must equal surpluses so, for the world as a whole, the international financial system is a closed system. Economies that run surpluses in their private transactions thereby acquire claims on the rest of the world. Those claims are held by the central bank of the economy in question. On the other hand economies that run deficits must incur debt that is held by the central banks in other countries.

While there is pressure on deficit countries other than the US to reduce their deficits there is no symmetric pressure on surplus countries to rein in their surpluses. In that way the present world system imparts the deflationary bias to the world economy. Note that Australia has pretty well avoided the fallout from the world's deflationary policies because of its links with China. In the meantime the actions of the US Federal Reserve System affect the whole world but the Federal Reserve is accountable only to the US and tends not to be concerned about the implications of its actions for the world economy. Yet it is of course vital to Australia that the rest of the world is strong with high economic growth in which our exports can thrive.

Years ago Keynes articulated these problems and put forward a set of proposals for what he called a 'clearing union' that would have addressed the imbalances in the world monetary system.[60] The upshot was the Bretton Woods agreement which established the International Monetary Fund that sought to provide liquidity to deficit economies. In addition, the General Agreement on Trade and Tariffs (now monitored by the World Trade Organisation) sought to maintain world trade links and prevent import restrictions as a response to current account difficulties on the part of member economies. The Bretton Woods agreement did not include a symmetrical treatment of surplus and debtor economies as Keynes had argued. This failing arguably led to its demise.

The global financial system needs to move beyond the present and include a mechanism that recognises that the actions of surplus economies are to provoke deflationary policies in other economies and to put pressure on surplus economies to eliminate their surpluses. When China was running massive current account surpluses[61] the US was running large

[58] Commission of Experts of the President of the United Nations General Assembly on Reforms of the International Monetary and Financial System (2009) *Report*, NY: United Nations.

[59] Tingle L and Coorey (2014) 'Hockey defends Fed taper putting US first', *The Australian Financial Review.* 5 February.

[60] See Keynes JM (1971) *The Collected Writings of John Maynard Keynes: Volume 25 Activities 1940–1944: Shaping the Post-War World: The Clearing Union*, London: Macmillan. An earlier discussion was presented in Richardson D (1985) 'On proposals for a clearing union' *Journal of Post Keynesian Economics*, Vol 8(1), pp. 14-27.

[61] Those surpluses peaked at 10.1 per cent of GDP in 2007 and have moderated to an estimated 2.5 per cent of GDP in 2013 according the IMF (2013) *World Economic Outlook Database*, October.

deficits and acted unilaterally to put pressure on the Chinese to appreciate their currency in the hope that it would ease the US deficit. That sort of action needs to be pursued in a multilateral framework or agreement that uses the surpluses of the surplus economies to finance the deficits of the deficit economies. We might ask the hypothetical question of whether China would be so willing to accumulate massive foreign currency reserves if a good part of those reserves had to be held in the Australian dollar but also the Turkish lira, Indian rupee, Pakistani rupee, Venezuelan bolivar, and Egyptian pound not to mention Greek debt issued in euros.

Now that Australia is chairing the G20 group of economies it is important that it uses its influence to bring asymmetry back on the table as an issue to be addressed. At all possible occasions Australia should be pushing for equal and opposite treatment of deficits and surpluses in the world monetary system.[62]

One of the major problems highlighted since the global financial crisis is the plight of the periphery economies in the Eurozone. Many of the market mechanisms that are available to Australia are not available to them. For example, Australia's currency is likely to devalue in the event that Australia's economic performance fell below the rest of the world. That can no longer happen in the case of Greece and other Eurozone countries. In the case of an Australian state or US state that got into trouble there would be a fiscal solution to some extent. For example, Tasmania's economic performance has been lagging the rest of Australia recently and as a result, Tasmania is experiencing the automatic stabiliser effects of higher unemployment benefits and lower income tax collections. This would have the effect of increasing the net flow of funds to Tasmania and as a result cushion the impact of the downturn in Tasmania to some extent. Of course the EU has no such fiscal mechanism.

Australia should promote this understanding of the Eurozone and urge mechanisms to redress deficiencies in its financial system. In this way we would be acting in our own enlightened self-interest since financial instability beginning anywhere in the world has the potential to affect us all. The way Australia engages with the rest of the world has also been an important issue with the current exchange rate mechanism contributing to the closure of the Ford and Holden manufacturing facilities and the loss of other uncompetitive industry. The Australian exchange rate mechanism allowed the mining boom to put upward pressure on the exchange rate and so squeeze out other economic activity. Essentially a massive inflow on the capital account was allowed to squeeze the export sector and so widen the current account—an example of the 'transfer mechanism' at work.[63] However, once the boom is over we move into the production phase and the additional exports will maintain upward pressure on the exchange rate. That will be offset to some extent by the profits payable abroad because of the high foreign ownership of the mining sector. As a consequence we are likely to see a moderation in the value of the Australian dollar and the rest of the economy should be more competitive once again. However, Australia will never retain some of the industry it lost. That raises the important issue of whether we could have better handled the peak capital inflow years so as to not squeeze out economic activity that may never return yet would have remained viable in the absence of the boom.

Various proposals were put for some sort of a stabilisation fund of the type used in Norway or converting the Future Fund into a sort of currency stabilisation mechanism. The details are not important but the essential element is to meet the monetary inflow associated with capital

[62] To be clear here, deficits and surpluses refer to current accounts plus the capital account but excluding official borrowing or lending on the part of central banks. That incidentally would mean that Latin American style official borrowing of the 1970s and 1980s would no longer be necessary if similar circumstances were to arise.

[63] See Denniss R. and Richardson D (2011) *Mining the Truth: The rhetoric and reality of the commodities boom*, Institute Paper no. 7, The Australia Institute, Canberra. The 'transfer mechanism' and its working is described in Johnson HG (1976) 'Notes on the classical transfer problem' *Manchester School of Economics and Social Studies*, vol. 44, pp. 211-19.

inflows with a monetary outflow such as for the purchase of foreign assets by a currency stabilisation mechanism.

The aim of the Norwegian Petroleum Fund seems to be the accumulation of a sum of money that will be available when petroleum resources begin to run out. In that way there will be, in theory, a perpetual benefit as a result of the current petroleum reserves. Of course, Norwegian petroleum revenue is a very large share of government revenue compared with mining revenue in Australia. In a good year, the Australian state mining royalties and the Federal resource rent taxes on Australian minerals are unlikely to reach much over one per cent of GDP under current settings.[64] By contrast the government revenue from petroleum in Norway has averaged around 20 per cent of GDP over the decade to 2012.[65]

Australia is a large order of magnitude different from Norway and any initiative in Australia that tried to emulate the Norwegian experience would operate on a much smaller scale. Nevertheless, if properly managed, such a fund could have offset much of the appreciation in the value of the Australian dollar and thus cushioned the contraction in manufacturing and other trade-exposed industry.

Of course, any equal and opposite flow of money would do the same job as the Norwegian Petroleum Fund or an Australian version of it. For example, on the assumption that Australia will continue to experience resource-boom revenues for some time to come, perhaps we should be seeking some other potential flow of perhaps $20 to $30 billion per annum. One candidate would be reversing the large inflow of foreign funding accounted for by the Australian banks. That theme is taken up below.

There are other options that could be explored such as encouraging mining companies to invest their revenue surges in offshore assets. Equally, government revenue surges attributable to mining could be invested in the Future Fund.

There is also a natural reverse flow associated with some of Australia's resources. For example, some of the gas projects may have very little impact on Australia if they:

- use capital equipment sourced from abroad
- involve very little employment or subcontracting with Australians
- generate profits for foreign owners

In that case, most of the revenue from operations would be sent abroad as payments to foreign suppliers and income for foreign owners, with little more than government taxation revenue remaining in Australia. Australian figures would show the export income but would also record payments flowing back overseas. Even those figures would be notional, since most of the money would never be transacted in Australia. This situation would solve the transfer mechanism but is likely to be regarded by most people as unacceptable.

Whatever the exact mechanism, there would seem to be a strong case for examining the options for Australia seriously. Anything that can neutralise the transfer mechanism would have the effect of avoiding the disruption to the rest of the economy that Australia periodically experiences as a result of resources booms.

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[64] Royalties in 2011-12 were $11.7 billion (see ABS (2013) *Mining Operations, Australia, 2011-12*, Cat no 8415.0, 31 May) while the Federal resource rent taxes were $1.3 billion for the same year (see Australian Government, *Budget Strategy and Outlook, 2013-14: Budget Paper No 1*, May 2013). If the MRRT remains in place then the resource rent taxes would increase to around $5 billion in 2016-17 which implies total mining revenue for all levels of government would be barely above one per cent of GDP.

[65] International Monetary Fund, *Norway: Staff report for the 2013 article IV consultation, IMF Country Report No 13/27*

Arguably the horse has now bolted, or at least most of the horses have now bolted. However, there remains a lot of additional mining investment that will occur over the next several years and it is likely that we could still use a currency stabilisation mechanism to further reduce the value of the Australian dollar and so avoid losing further industry and possibly assist in the creation of new industries that might compensate for the decline in mining investment.

Earlier, when the current account deficit on the balance of payments had been a problem, the former Treasurer, Peter Costello, suggested that the trade deficit is Australia's 'biggest economic challenge'[66] and drew attention to the strength of the currency as contributing to the large current account deficit at the time. Costello put some of the blame on the banks by suggesting it was the foreign borrowing by the banks in particular that was putting upward pressure on the exchange rate which, in turn, tended to widen the current account deficit.[67]

At the end of September 2013 the banks' total foreign assets (lending and other investment) was $435 billion and liabilities to foreigners (their deposits etc) were $783 billion. This means the banks lend out a lot more than they raise in Australian deposits. This is basically financed by net foreign borrowing of $348 billion.[68]

The banks encouragement of foreign capital inflows to that extent must have a significant impact on the Australian economy. It is also worth noting that the large overseas borrowings do not necessarily have implications for the stability of the banking system. Mr Macfarlane has made the point that the Australian Prudential Regulation Authority carefully monitors the banks' balance sheets and such things as their overseas exposure. He added that so long as the banks' foreign currency exposures are appropriately hedged[69] then there should be no implications for the stability of the Australian financial system.[70]

Of course this interpretation is not how the banks see things. Gail Kelly, CEO of Westpac, has pointed to the funding gap in Australia and suggests that the present structure of regulations inhibits the banks in raising deposits from their domestic customer base and forces banks to seek offshore and wholesale funds. There is a gap that she puts at around $600 billion between what the banks have lent and their domestic deposits. Ms Kelly thinks that gap has remained about the same since the eve of the global financial crisis. That gives an interesting perspective on the part of the banks however, the national perspective looks different.

Australia has been running a current account deficit of $46 billion[71] in calendar 2013 which is financed by an equal and opposite capital and financial account (subject to errors and omissions). That is also the value (again subject to errors) of the increase in Australia's net international liabilities including both debt and equity.[72] Most of the increase tends to occur through increases in Australia's net foreign debt. The increase in net foreign debt is of course what Ms Kelly attracts when Westpac seeks wholesale deposits from abroad.

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[66] Uren D, "Trade deficit Costello's big fear," *The Australian*, 29 January 2005, p. 2.

[67] ABC, 'Costello assesses the economy', interview with Tony Jones, *Lateline*, 8 March, 2005

[68] *Reserve Bank of Australia statistical tables*, 18 March 2014. Total foreign borrowing it taken as total bank liabilities less resident liabilities which is then netted against the similar items for bank assets.

[69] If a bank has a US$100 net debt then it has an equal exposure to the US$. If however, it buys US$100 for delivery in a year's time it is said to have hedged that exposure.

[70] Standing committee on economics, finance, and public administration (2005) 18 February

[71] Balance of payments figures and debt figures below come from ABS (2014) *Balance of Payments and international investment position, Australia, Dec 2013*, Cat no 6302.0, 4 March.

[72] This of course has to be qualified because of valuation effects.

At the end of December 2013 Australia's net foreign debt was $853 billion. It was up from around $600 billion in June 2008 and has been increasing roughly in line with Australia's current account deficit on the balance of payments.

Those sorts of foreign investment figures are always going to mean that Australians are acquiring fewer assets than they are issuing as liabilities. The end result is that banks that are central to the financial system, such as Westpac, find they are attracting less deposits than they need to finance those customers who want to incur liabilities. Hence, they borrow offshore or wherever else they can fund the shortfall.

The logic of the Australian balance of payments position suggests that it is inevitable that someone in Australia must be a net borrower abroad to match the imbalance between the domestic acquisition of assets and the domestic incurrence of liabilities. The way Ms Kelly puts it, domestic shortages of funds cause banks to borrow abroad. However, from the national perspective, banks are in the market for wholesale funds and are able to give foreign fund holders much better deal than the main money markets where interest rates range from 0.13 per cent in the US to 0.5 per cent in London for overnight funds. That suggests capital inflows are not passively responding to the current account deficit but may be initiating at least some of the capital inflow along with the attraction of the mining boom for foreign capital. Hence, we would suggest that Costello's hypothesis is borne out in today's circumstances.

The proposition that a dollar of US$ capital inflow has no impact if hedged in the futures market is not clear and it might be tested further. To some extent the futures market does not act like a real market. Most buyers and sellers deal with a market making financial institution which charges at cost plus mark-up.

Overall the story seems to be that banks have resorted to massive overseas borrowing to finance their domestic lending. A lot of that domestic lending ends up as the increase in consumer debt that has sustained consumer spending and contributed to the negative savings of the household sector. These raise a number of issues that are beyond the scope of this paper. The important thing is that bank behaviour may be behind the widening current account deficit.

Australian financial adventures offshore

Recent press reports suggest that the ANZ has experienced issues in Cambodia with its majority-owned subsidiary. This follows earlier problems in Vietnam. The NAB has continuing problems with the performance of its UK holdings and years ago had financial problems with its HomeSide investment. The latest figures show that Australian direct investment abroad in the finance and insurance industries was $115 billion or 31 per cent of all foreign direct investment abroad.[73] All but $3 billion was equity investment. Equity investment of that magnitude in the finance sector is likely to support foreign assets of ten times or more than that figure. It is possible we are looking at something of the value of around a trillion dollars. That of course is a guess but there are no relevant figures collected and published by the Australian regulators. That should be addressed.

Many Australian governments and the industry itself have expressed the ambition of Australia becoming a regional finance hub and for Australian institutions to increase their presence in the rest of the world. However, many of those ventures seem to have been unsuccessful as the above examples illustrate.

[73] The figure increases to over 50 per cent if we ignore mining. ABS (2013) *International investment position, Australia: Supplementary statistics, 2012*, Cat no 5352.0, 2 May.

During the global financial crisis many of the economies that were most severely affected were those such as Greece, Iceland, Ireland, Portugal and Spain. The UK had financial systems with large exposures to foreign assets that rendered them vulnerable to financial difficulties emanating from the rest of the world. Of course the US was most implicated and we have already spent time discussing the deficiencies in the US regulatory system.

We think there are clear dangers in Australian banks being exposed to foreign activities which may be poorly regulated. Taxpayers in the rest of the world have had to pay heavily for the regulatory failures of the US (including the heavy cost to taxpayers in the US itself). These concerns are the same whether we are talking about some sort of regional hub in Australia from which international banking takes place or the overseas activities of Australian banks themselves. Notermans in his study for the EU points out that the problems in Iceland, Latvia and Ireland around the time of the global financial crisis were the direct result of 'policies aimed at turning these countries into financial hubs'.[74]

The Committee will have heard of proposals whereby banks use one hundred per cent equity in making loans to business. We do not think we need to go to that extent in so far as domestic banking is concerned however, that level of capital adequacy may well be appropriate for loans abroad or the overseas activities of Australian bank branches.

Government finance

Years ago following the 1996 National Commission of Audit the Howard Government introduced accrual accounting into the budget sector and published balance sheets, operating statements, changed definitions and terms among other things. The intention seemed to be to introduce private sector concepts as much as possible into the public sector. At the same time we saw more use of corporate and household budgeting analogies brought into the discussion of government finances. However, there has been serious confusion on the part of many people about appropriate ways of thinking about government when they take the private analogy too far.

People who should know better often demonstrate gross misunderstanding by, for example, suggesting that 'sooner or later governments run out of money and are unable to maintain expenditure'.[75] Whatever views we have about the role of government in the economy we should at least try to ensure that we have an accurate understanding of the concepts and magnitudes involved.

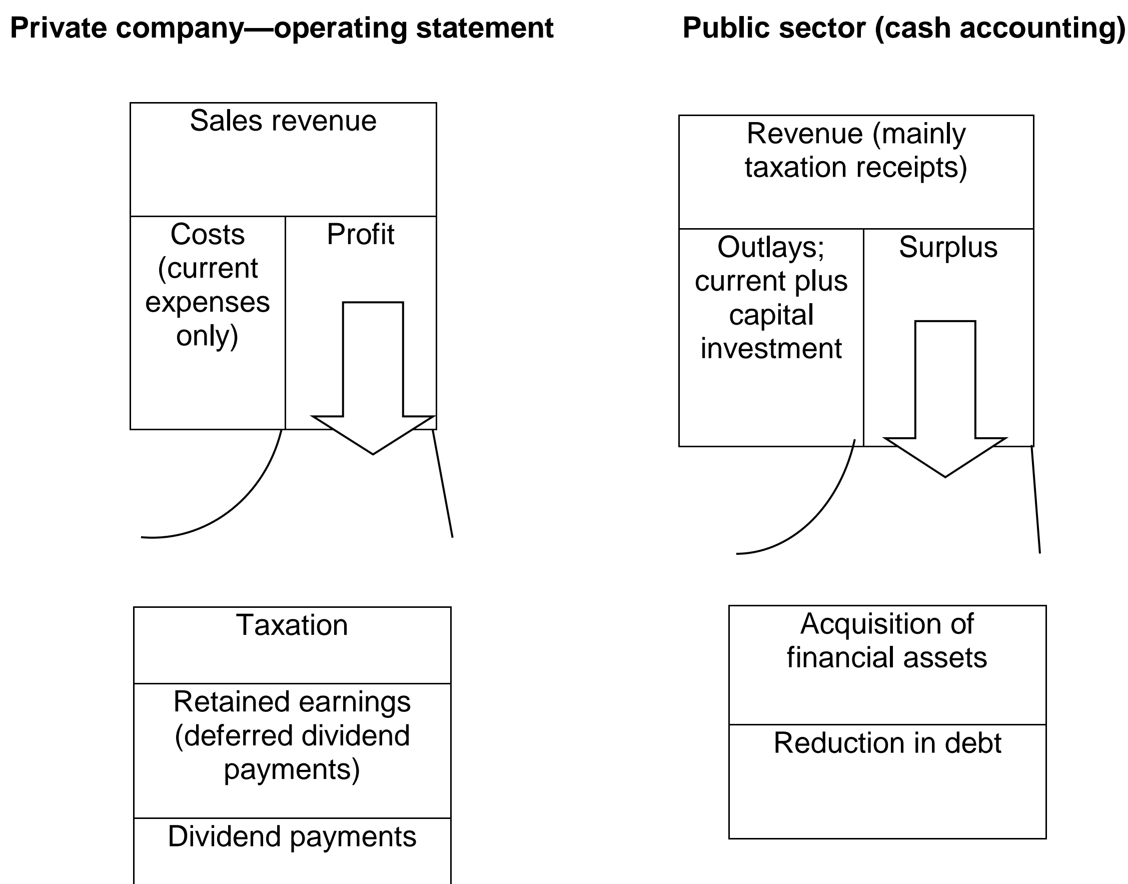
Surplus thinking, primarily the confusion between private profit and a government surplus, is a symptom of private-sector principles being applied inappropriately to the public sector. The owners of a private business clearly hope it runs at a profit so that it can both survive and pay a dividend to its owners. The payment of a dividend by a private company is a distribution of profit to the company's shareholders and is not counted as a cost to the business. That is, the objective of a private firm is to generate more revenue from selling a product than the costs incurred in making that product so that profit can be generated and then distributed to the owners of the company. The objective of a government, however, is to raise resources from the community in order to fund public activities or investments that, for various reasons, are better performed by government. The pursuit of a budget surplus is therefore the pursuit of excessive tax collections relative to the desired level of public spending.

[74] Notermans T (2013) 'Reforming finance: A literature review', Financialisation, economy, society and sustainable development, No 8 working paper series.

[75] Greber J (2014) 'Everyone must bear budget burden: Hockey', The Australian Financial Review, 1 April.

The following figure shows some of the conceptual differences between commercial and public sector accounting. The public sector accounts illustrated here are based on the cash accounting figures in the budget papers.[76]

Figure 2: Spending and revenue: Private vs public treatment



Note: Investment is not included in the company's operating statement

Figure 2 allows a comparison of the flows into and out of the corporate and public sectors. Both diagrams show funds coming in at the top level: the main source of funds for the corporation consists of its sales revenue while the main source of revenue for the public sector consists of taxation receipts. At the next level, the company incurs costs when it pays for labour, materials and a wide range of other items necessary to produce its output. If it is successful in keeping its costs lower than its revenue, it will generate a profit. At the same level, outlays for the public sector include such things as pensions and defence through to flood relief and, significantly, all capital investments—new buildings and computer systems for example.[77] If the public sector spends less than its revenue, it produces a surplus.

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[76] The Treasurer and most commentators use the cash figures. However, the budget papers also include accounts based on accrual concepts that attempt to emulate the private sector to some extent. See Australian Government, (2013) *Statement 3: Fiscal strategy and outlook 2013–14,* .Budget Paper no 1.

[77] Capital investments themselves are not included in the private sector's operating statements because long-life assets such as plant and equipment will contribute to the firm's operations over many years. Instead, the private sector can include 'depreciation' of the capital stock in its operating statement. 'Depreciation' in a particular year can be thought of as a rough measure of how much the capital stock has 'worn out' in that

The diagram traces what happens to the corporate profit and the public surplus. In the case of corporate profits, some is likely to be paid to the government in tax, some may be retained in the business as 'retained earnings',[78] and some is likely to be paid to the owners of the corporation as dividends. Public sector surpluses, however, can be used either to acquire financial assets or to repay debt.

To some extent, the public and private concepts of income and expense are analogous to each other; however, there are potential errors if those analogies are pushed too far. For example, private expenses are a necessary input to production and a good manager will endeavour to keep them as low as possible. However, government outlays include such items as the age pension, which is really a means of sharing the income generated in Australia, as is the purchase of tanks, guns, aircraft and ships where the aim is to maximise Australia's defence preparedness. Paying lower wages to contractors is unambiguously good for a company, but paying lower pensions to pensioners is not unambiguously good for the country.

While income and expense in the public and private sectors have something in common, private profit and public sector surpluses are fundamentally different. Profits are not analogous to a public-sector surplus and the concept of profit and dividend distribution cannot apply to the government. The notion of a profit is meaningless from the point of view of public accounts.

Any attempt by a government to pay a 'dividend' by giving money back to its owners (the people) eliminates the surplus. That is, when governments return money to its owners, it is either by way of a tax cut or a payment such as a social security benefit, two items (treated as an expense rather than as a dividend) that both reduce the surplus.[79] This example illustrates how private sector concepts are inappropriate in the public sector.

The impossibility of returning a budget surplus to the community without simultaneously reducing that surplus highlights the fundamental illogicality of using the private sector analogy of profit to evaluate the desirability, or otherwise, of a surplus. Furthermore, it leads to the logical slip that suggests surpluses can be accumulated for use at a later date. This is discussed further below.

The notion that because a private profit is 'good', a public surplus must also be good seems to have found its way into the budget papers, which appear to reflect the view that a government surplus is indeed a valuable target of public policy. For example, despite the success of the stimulus package, the 2010 budget papers announced that the government is determined to return to surplus and had imposed a two-per-cent spending growth limit to assist it to do so. As the budget papers explain:

> *Until the budget returns to surplus, government intends to maintain a tight limit on spending in the short term, which will impose a massive constraint on what activities it can undertake by way of health, education, the environment and other initiatives.*

Rather than offering society a choice between increased social welfare and other spending initiatives or fiscal 'discipline', the apparently objective targets seem to have been designed

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year's operations. (Instead of actually measuring the latter, depreciation tends to be computed using arbitrary accounting rules and conventions.).

[78] 'Retained earnings' are after-tax profits that are not distributed to the owners. Companies tend not to distribute all their profits to their owners, retaining some of the money for various reasons such as expanding the business through new investments. Although the owners do not have the cash in their hands, they will benefit because the increase in company assets is likely to increase the value of the organisation.

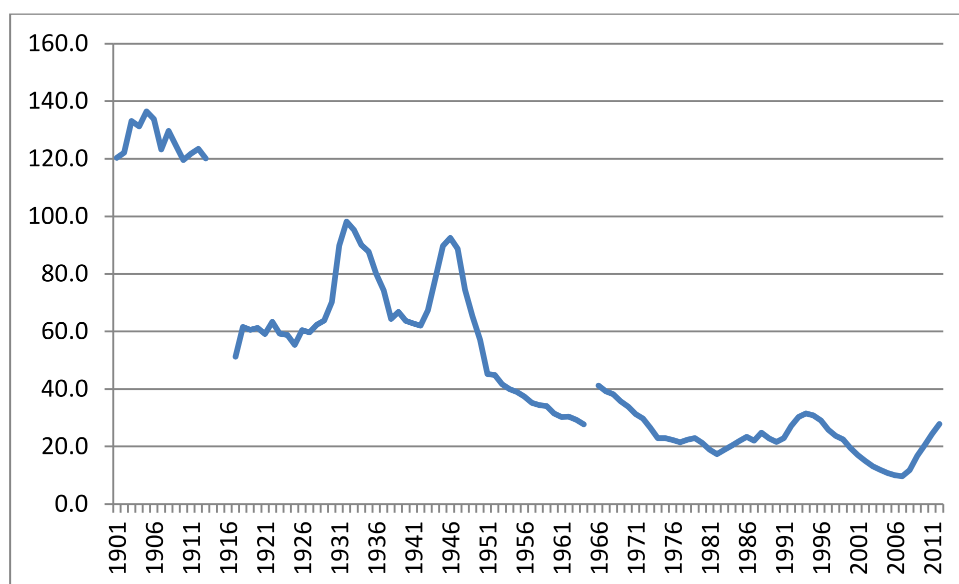
[79] It could be returned in kind through additional spending on education and health, but that would also eliminate the surplus.

as some sort of quasi-scientific canon to rule out-of-bounds otherwise worthwhile objectives and conceal the available alternatives. If these rules are going to impose limits on what governments can do, there should be some solid argument behind them. Unfortunately, that is not the case. An obsession with surpluses is dangerous but, when combined with arbitrary rules about the level of tax governments can collect, the result is an undemocratic attempt to conceal choices from voters.

A feature of present debates is that debt on the part of a government is taken as bad and the government is supposed to pursue surpluses. There is now a commitment to a surplus of one per cent of GDP which can be seen as a commitment to tax the average taxpayer much more than is necessary to fund government services. GDP in 2013-14 is likely to be $1,574 billion[80] which means to run a surplus of one per cent of GDP Australians will need to be taxed some $1,500 per annum on average[81] more than they should pay to fund the ordinary services of government.

It should also be stressed that Australia's debt to GDP ratio remains at very low levels, even in relation to our own history as is shown in Figure 3.

Figure 3: Debt to GDP ratio (%)



Source: IMF historical data bases.

The notion that borrowing today imposes a 'burden' on future generations needs to be examined, especially in view of the fact that debt was almost 100 per cent of GDP in 1950[82] and the Australian economy did not seem to suffer in subsequent years. Upon closer examination, the notion breaks down and it is easy to see why. Suppose there were a large amount of government debt on issue at this time, perhaps $1000 billion paying a yield of five per cent, costing the government $50 billion per annum in interest. Suppose that there is a balanced budget so that taxes are higher by $50 billion to finance the government's interest bill.

[80] Based on TAI calculations using ABS (2013) Australian system of national accounts, 2012-13, Cat no 5204.0, 1 November and Australian Government (2013) Mid-year economic and fiscal outlook, December.

[81] This figure assumes roughly 10 million taxpayers

[82] Gross debt measured by securities on issue was over 100 per cent of GDP according to TAI estimates based on Reserve Bank figures.

Some observers might refer to the $50 billion additional tax as the 'burden' in question but that tax goes to make interest payments to other Australians. If the additional tax is a burden, the additional interest payments of $50 billion must logically be the opposite of a burden. The payment of $50 billion by some members of the economy is matched by an income of $50 billion to other members of the economy. In fact, if everyone held equal amounts of government debt and paid equal taxes there would be no change in anyone's income.[83]

Similarly, there would be no change in total net income in Australia. Of course, people do not pay equal amounts of taxes and do not hold equal amounts of government debt—rather, the holders of government debt are likely to be concentrated among higher-income earners, as are those with high tax liabilities.[84] Hence, it is incorrect to reason that a future cohort of people is somehow burdened by the actions of a previous generation when the net income of the future generation will be unchanged. Indeed, some of that future cohort may well be better off simply due to the fact that their parents have been saved from a prolonged period of unemployment and poverty. In addition, assets funded by government debt have made everyone better off, from the Sydney Harbour Bridge to the Snowy Mountains Scheme.

From an intergenerational perspective, the one bequest an earlier generation can genuinely make to a future generation consists of the physical assets of the nation, including everything from the local town hall building to the environmental quality of Australia's river systems. There are, of course, a host of issues relating to the preservation of physical assets in Australia but those are beyond the scope of this paper.

In some of the academic treatments it is assumed that the government debt will eventually be paid off. This is a pure artifice and is really only invoked to make the mathematics tractable. For example, if we are trying to estimate the optimal pattern of government spending over time then it helps to restate the problem as maximising benefits subject to a constraint. The assumption that all government surpluses and deficits must sum to zero is a convenient constraint to use for that purpose. If we do not really care about the level of government debt (and we should not – the fiscal stance should reflect the needs of the economy) then the question of the best pattern of government spending is open-ended.

Unless we knew for sure that the Australian Government was about to come to an end there would be no reason to ever pay off all outstanding government debt. Notice for example that according to the latest BHP Billiton annual report that company had outstanding debt of $66 billion. BHP was established in 1885 and has had 129 years to reduce its debt but clearly has chosen not to do so. Note too that the head of National Australia Bank, Cameron Clyne, has said that the Commonwealth Government has a 'lazy balance sheet'. He put the view that the government should be borrowing more and exploiting its good credit rating and access to cheap capital. In his view government can finance long-term roads, rail and ports 'far more effectively'. He also said 'we don't have enough [debt]. We have a lazy balance sheet…We have a unique window as a AAA nation with strong demand for AAA debt to issue that debt and divert it to productive infrastructure'.[85]

Mr Clyne is absolutely right. As already argued above, the government has been able to borrow at well below four per cent or well under two per cent in real terms. Periods of low interest rates are the perfect time for investing in capital intensive projects. The hurdle rates

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[83] Depending on the actual pattern of interest payments and taxation there may well be a redistribution of income from rich to poor or *vice versa,* which may warrant government action. However, that does not seem to be what the critics had in mind.

[84] Some of the debt will also be held by corporations and some of the tax will also be paid by corporations and other bodies, but these are ultimately owned by individuals. As pointed out in Note 7 above, government debt that is held externally is excluded.

[85] Bennet M (2013) 'Clyne pitches big-picture view on debt' *The Australian*, 2 August.

of return that projects need to generate is so much lower and the borrowing costs are easily serviced.

We used the example of governments running out of money in the introduction to this section. Just to be clear, in principle it is possible for a particular household, company or local government to be constrained by their finances so they may indeed run out of money. Money is just an IOU of the government (or the bit of it that includes the Reserve Bank) but a unique IOU that is never presented for repayment and if it was it would only be redeemed in other IOUs. Most money is held and transferred electronically so there is not even an issue of running out of a physical entity.

Conclusion

We agree with Nobel prize winner in economics, Joe Stiglitz, when he says that the policy mistakes in major financial centres were the result of inappropriate economic analysis and the associated belief that an unfettered market will deliver the best results. In fact the approach involved turning a blind eye in the midst of deregulation which allowed many of the pillars of the establishment to be taken over or compromised by frauds and criminals. Australia has fared better than many other economies but has not been immune as the examples of Storm Financial and even the incidents at the National Australia Bank testify. In describing the faults of the financial system it is hard to match the passion and imagery of people such as Warren Buffett and Paul Volker. But we have to be conscious of the fact that financial systems can go badly awry at huge cost to the rest of the economic system.

A root and branch review of the financial system is a very large task and the present submission merely touches the surface. We urge the Committee to follow the terms of reference for a 'root and branch review' and reject the view that the Committee should just undertake 'a broad and comprehensive review that reaffirms the significant strengths of the current system'.[86]

At the heart of the Australian financial system are the four big banks and they have given us the most concentrated banking structure in the world. As a result of the concentration the banks earn excessive monopoly profits. The way the banks extract monopoly profit is equivalent to a private tax on transactions. The whole justification of private market solutions to the provision of goods and services is based on a competitive environment in which monopoly rip offs are unsustainable and competition reduces all profit to modest rates of return on the capital advanced in business. This does not characterise the Australian banking system nor the other top listed companies in Australia with which the banks are often compared.

We quoted Milton Friedman whose view is that while monopolies are always bad, government owned monopolies are the least bad. Private and regulated monopolies may appear attractive but in the case of the US for example we have seen regulatory capture to the extent that regulation hardly existed. Even in Australia we have seen a lot of movement of senior people in and out of banks and their regulators. Though of course the problems seem clearer in another country and involving people we know less well.

Government-owned enterprises and the promotion of member-owned alternatives are worth pursuing as bulwarks against the exercise of private power. In addition there is a good case for splitting the banking system into the utility functions related to the payments system and the lending functions which are less likely to favour large uncompetitive conglomerates. In this regard we take up the suggestions of the former head of the Bank of England, Mervin

[86] Kelly G (2014) 'Murray inquiry must review not stifle banking system', *The Australian Financial Review*, 31 March.

King. However, in the absence of genuine root and branch changes the big four banks in particular have to be carefully regulated.

While banks in the US and elsewhere have to be heavily regulated to protect themselves from themselves in Australia it is the need to protect customers from institutionalised profit gouging that is the most important thing that should focus the attention of the Committee. However, most of the policy thinking about banks reflects the view that competition should be used to check the power of the banks. Though competition has been the basis of policy ever since colonial times through to attempts to introduce competition from foreign banks, credit unions, building societies, mortgage originators and so on, our examination of the history of banking suggests that big banks thrive on competition and competition has not really checked the tendency for a concentration of monopolistic banks.

Consumers are equally disadvantaged in dealing with the super industry, insurance and other parts of the financial system. Most parts of the financial system involve a large information asymmetry on the one hand and lack of competition on the other. However, in many cases cooperatives offer a useful alternative to the for-profit sector. Unfortunately cooperatives have no incentive to let people know of their existence while, for example, the big four banks happily spend a billion dollars a year in advertising. Unfortunately the advertising is without real content and merely reflects oligopolistic brand image strategies.[87] The Committee should look at ways that the benefits of cooperatives can be better disseminated around the community.

The share market is a terribly important part of the Australian financial system. Our concern in this submission is that the Australian economy is dominated by highly concentrated and uncompetitive industries. We need only think of Coles and Woolies and the banking system as examples but there are many more. Our preliminary work suggests not only are there few competitors in each market but the ones we examined have common owners. Simple economic theory tells us that if there are common owners then they are going to want the individual firms to act as one. The Committee should also consider this question and ask itself how we might manage to ensure that apparently different entities do not have their independence compromised by common ownership.

Australia will always be heavily affected by the international financial system through its transactions with the rest of the world. To date the impression is that official policy tends to accept the world institutional structure as it is and supports a rather laissez faire approach to transactions within that institutional structure. However, it has been known for decades that the international monetary system treats creditor and debtor nations differently. Pressure is put on debtor nations to contract their economies while there is no pressure on creditor nations to do the opposite. The result is that there is a net deflationary bias in the world economy.

The best means of addressing those world imbalances was put by Keynes to the Bretton Woods conference in 1944. It may not be feasible to go back to that point and push for his preferred system but it is possible for Australia to push at all fora for a more symmetrical treatment of balance of payments deficits and surpluses.

Australia's own experience recently includes huge gyrations in the exchange rate as a result of the resources boom and the coming aftermath. The Committee needs to consider the alternative institutional arrangements that might have better protected Australia during the recent past and what might be done in the future. During that period the banks were large

[87] Those who insist that advertising conveys an important information content might ponder the St George advertisements that suggest it is a small, independent bank. St George of course has no corporate identity and is merely a division within Westpac.

importers of capital. We tend to think of the financial and capital account of the balance of payments as passively responding to the current account. The banks see themselves in that context; however, Peter Costello certainly believed that the banks' actions were actually inducing a capital inflow which then put upward pressure on the exchange rate. Our submission supports that view and so suggests the Committee look at options to stop or moderate the banks overseas borrowing.

A major concern with the international aspects of the financial system is Australia's own financial system and its role in the offshore ventures. It could be argued that Australian banks for example are already too big to fail and that, if anything, we should be trying to limit further expansions. But more importantly we have seen examples in the rest of the world where countries have had enormous burdens thrust on them by the failure of their institutions' overseas ventures.

This submission makes brief comment about government finance. A committee of experts should be able to advise a government on exactly how government finance works and how it can be made to work to the benefit of the community. To date political parties have often used inappropriate household and corporate analogies to illustrate their approach to government spending, taxing and any debt or deficit implications. We think there should be a more mature approach and the Committee should debunk the notions that government debts and deficits are inherently bad.

Appendix: Links to earlier papers

Banking

A licence to print money: Bank profits in Australia http://www.tai.org.au/node/1611

Money and Power: The case for better regulation in banking http://www.tai.org.au/node/1650

Submission to the Senate Economics Committee inquiry 'Competition within the Australian banking sector' http://www.tai.org.au/node/1318

The profit in home lending http://www.tai.org.au/node/1890

The rise and rise of the big banks http://www.tai.org.au/node/1926

Superannuation

Can the taxpayer afford self-funded retirement? http://www.tai.org.au/node/1884

Choosing Not to Choose: Making superannuation work by default
http://www.tai.org.au/system/files_force/dp103_7.pdf

Super for some http://www.tai.org.au/node/723

Time to get engaged with super? http://www.tai.org.au/node/1954

The case for a universal default superannuation fund http://www.tai.org.au/node/34

The great superannuation tax concession rort

www.tai.org.au/system/files_force/super_tax_concessions_final_7.pdf?

Cooperatives

Who knew Australians were so co-operative? The size and scope of mutually owned co-ops in Australia http://www.tai.org.au/node/1902

Appendix: Terms of Reference

Objectives

The Inquiry is charged with examining how the financial system could be positioned to best meet Australia's evolving needs and support Australia's economic growth.

Recommendations will be made that foster an efficient, competitive and flexible financial system, consistent with financial stability, prudence, public confidence and capacity to meet the needs of users.

Terms of reference

1. The Inquiry will report on the consequences of developments in the Australian financial system since the 1997 Financial System Inquiry and the global financial crisis, including implications for:
    1. how Australia funds its growth;
    2. domestic competition and international competitiveness; and
    3. the current cost, quality, safety and availability of financial services, products and capital for users.
2. The Inquiry will refresh the philosophy, principles and objectives underpinning the development of a well-functioning financial system, including:
    1. balancing competition, innovation, efficiency, stability and consumer protection;
    2. how financial risk is allocated and systemic risk is managed;
    3. assessing the effectiveness and need for financial regulation, including its impact on costs, flexibility, innovation, industry and among users;
    4. the role of Government; and
    5. the role, objectives, funding and performance of financial regulators including an international comparison.
3. The Inquiry will identify and consider the emerging opportunities and challenges that are likely to drive further change in the global and domestic financial system, including:
    1. the role and impact of new technologies, market innovations and changing consumer preferences and demography;
    2. international integration, including international financial regulation;
    3. changes in the way Australia sources and distributes capital, including the intermediation of savings through banks, non-bank financial institutions, insurance companies, superannuation funds and capital markets;
    4. changing organisational structures in the financial sector;
    5. corporate governance structures across the financial system and how they affect stakeholder interests; and

   6. developments in the payment system.
4. The Inquiry will recommend policy options that:
   1. promote a competitive and stable financial system that contributes to Australia's
      productivity growth;
   2. promote the efficient allocation of capital and cost efficient access and services for users;
   3. meet the needs of users with appropriate financial products and services;
   4. create an environment conducive to dynamic and innovative financial service providers; and
   5. relate to other matters that fall within this terms of reference.
5. The Inquiry will take account of the regulation of the general operation of companies and trusts to the extent this impinges on the efficiency and effective allocation of capital within the financial system.
6. The Inquiry will examine the taxation of financial arrangements, products or institutions to the extent these impinge on the efficient and effective allocation of capital by the financial system, and provide observations that could inform the Tax White Paper.
7. In reaching its conclusions, the Inquiry will take account of, but not make recommendations on the objectives and procedures of the Reserve Bank in its conduct of monetary policy.
8. The Inquiry may invite submissions and seek information from any persons or bodies.
9. The Inquiry will consult extensively both domestically and globally. It will publish an interim report in mid-2014 setting out initial findings and seek public feedback. A final report is to be provided to the Treasurer by November 2014.

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