To: The Senate Economics Committee
Re: Competition within the Australian banking sector

This brief submission aims to comment on the validity of a public option in the Australian banking sector.

The banking sector as a source of credit

The Australian banking sector provides a whole range of financial services to Australian businesses and consumers. This section focuses primarily on the banking sector as a source of credit.

The banking sector is the source of credit for most businesses and consumers. As recent history has illustrated, there are two key aspects to credit:

1. The cost of credit (usually measured in the combination of interest rates and fees); and
2. The availability of credit.

The first of these aspects, the cost of credit, is a function of a number of factors, one of which is clearly competition. It is well understood that in a banking sector with fewer competitors, banks can not only extract higher returns from consumers but, through increased economies of scale, they can effectively build economic barriers which stop new potential competitors from entering the market. Such a situation will not self-correct on its own and is sub-optimal from the point of view of the consumer.

The counter-argument to this is that, through those same economies of scale, efficiency gains can be made which result in a lower cost of production than could otherwise be achieved with smaller banks.

Therefore, it is not accurate to simply conclude that we need more smaller banks to reduce the cost of credit for Australian businesses and consumers. Instead, we need highly efficient banks that operate in a highly competitive banking sector. To achieve this, regulators need to strike a balance to ensure that the banking sector contains a large enough number of players to promote genuine competition while allowing players to grow to an adequate size to capture economies of scale and operate efficiently. In banking, a further and critical requirement for regulators is to ensure that, in this context, banks remain small enough and adequately contained to be allowed to fail in the event of a crisis. The notion that banks will be bailed out by the taxpayer if they grow too large and interconnected simply provides an incentive to grow too large and interconnected. The scary consequences for the taxpayer of regulators overlooking this particular factor are becoming increasingly clearer in the US today.

While the cost of credit is a highly contentious issue in Australia today, ensured access to credit for credit-worthy borrowers is an issue which should not be forgotten. Credit is like the air that the economy breathes to survive. When air is polluted it is a highly undesirable situation and should be addressed; however, when air is cut off, the consequences are catastrophic.

Access to credit typically becomes an issue during a financial crisis. Indeed, as was the case in the Great Depression, it was the lack of credit availability that turned a recession into a depression. Bank lending will always be, to some extent, based on a level of trust between the lender and the borrower. In a severe financial crisis, this trust can erode to a level where lenders no longer lend. Indeed, as we have observed in the US over the last two years, despite major government-funded bank bailouts and interest rates at near zero, lending has hardly increased at all.

A public option in the Australian banking sector

Unlike most corporate entities in our capitalist society, banks perform dual functions:

1. An economic function: to maximize shareholder value; and
2. A social function: to provide credit at a reasonable cost to businesses and consumers, the result of which leads to employment and economic growth.

It is because banks provide a social function that there is a role for a public option in the banking sector. This is not new and is already accepted in other areas such as:

- Healthcare: the private sector does its job of providing efficient and profitable healthcare to those who choose it, while Medicare provides a public option as a safety net.
- Education: the private sector offers specialized for-profit educational courses and training programs for those who choose them, while the public sector provides a base-level of education for all Australians.
- Infrastructure: the private sector can efficiently and profitably build toll-roads for those who choose to travel on them, while the government provides a public option in the form of alternative routes.

The undesirable consequences of the private sector entirely dominating social services are evident in areas such as:

- US healthcare: where research has clearly shown that the average American pays more for less; or
- US banking: where the recent bank bail-out was made by the government on the basis that, without such a bail-out, credit would dry up (indeed this was the very advice given to political leaders by senior banking executives). Instead, due to fears over the future of the economy and the resulting breakdown in trust between lenders and borrows, banks hoarded funds and refused to increase lending. Fortunately for the bankers, the bail-out did ensure that bonuses could be paid however.

This is by no means to say that the areas such as banking and healthcare should be dominated by the public sector. That would be a disaster. There is clearly a role for both, however. Most would agree that the private sector is highly efficient and innovative when it comes to maximizing profits; and from this search for profit, society can benefit in many ways. Thankfully, Australia is a capitalist society which understands the power of the private sector and has harnessed its power to benefit society relatively well.

Most economists agree (going all the way back to Adam Smith), however, that there is a role for government to play in a capitalist society, particularly in areas of social concern (such as education and defence) and the temporary failure of markets (such as fiscal policy and monetary policy).

In most cases, it is not for the public sector to crowd-out the private sector (indeed often, the public sector can hardly compete with the efficiency shown by the private sector) however a public option guarantees two things:

1. A lower-bound on the quality of the service being offered vis-à-vis private sector offerings; and
2. Guaranteed access to the service, especially during times when private sector offerings diminish.

A public option in the banking sector could be designed so as to provide a basic level of service to consumers. This level of service would represent a lower-bound which would likely be exceeded by the more efficient private sector.

Furthermore, a pubic option in the banking sector has an interesting implication for monetary policy in the context of a financial crisis. A public option in the Australian banking sector could become the lender of last resort to credit-worthy borrowers (including small businesses and consumers). The last two years have shown that western monetary policy cannot ensure lending, it can only encourage it (for instance, by lowering interest rates). When the trust between lenders and borrowers erodes to a level experienced in the US, then credit dries up – even when interest rates are set to essentially zero.

An interesting counter-example lies in recent Chinese monetary policy. Positioned at the opposite end of the political spectrum, China's state-controlled banks were given loan quotas to fill during the recent financial crisis which forced credit into the economy. The rate of China's economic recovery has been remarkable (and Australia has been a key beneficiary from this recovery).

Of course, there is no free lunch and it is highly possible that such state-controlled lending will result in loans that cannot be repaid. This could very well create problems in China's banking sector going forward. While China's state-run banking system is not a model for Australia's future, there is likely a lesson here to be learned.

A public option in the Australian banking sector could simply act as a lower-bound on the quality of service and a lender of last resort to credit-worthy borrowers during crises in which private-sector banks refuse to lend.

A key issue to be resolved would be the extent to which taxpayers guaranteed the creditors of the public option bank. This is likely the key argument against such a public option. The purpose should not be to place the private sector at an unfair competitive advantage. The public option should simply enjoy the same taxpayer protection as the private sector. Such a debate needs to carefully examine the extent to which taxpayers are already on the hook for Australian banking sector losses both explicitly (through the Australian Government Guarantee Scheme for Large Deposits and Wholesale Funding) and implicitly (through new schemes which the future governments will enact in future crises).

Thank you for the opportunity to contribute to this inquiry.

Andrew Macken