Competition within the Australian Banking Sector

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Finance industry regulation, and the banking system within that, are an essential element in maintaining economic growth within a relatively stable economic environment. The growth of all such regulation must occur over time in response to circumstance, environmental change and regulatory innovation. Both the ability for governments through the public service to inform itself of conditions within the industry and for actions to be taken are continuously evolving as advances in both banking practice and regulation continue.

But irrespective of what measures are taken, crises within the financial system can never be eradicated because of the nature of finance itself. Banks, in particular, are always trading as technically insolvent since they cannot cover all of their liabilities should confidence in either the individual bank or in the banking system in general take place. An economic downturn of sufficient severity, irrespective of where it begins, will drain capital from the financial system, increase the rate of default on loans and put such institutions at risk.

Moreover, the most common point of origin for recessions is in the financial system itself. And in addition, the potential for a downturn is all the more likely the longer it has been since any previous downturn and the less severe the economic penalties that were meted out to those who were directly affected during that previous downturn. The three greatest dangers to the financial system – innovation, complacency and moral hazard – will ensure that over time banking crises will occur from time to time. It is therefore necessary to have in place institutions and policies that can deal with such exceptional circumstances as they take place.

And while there is a role for governments to ensure that such financial institutions are behaving according to their charters and within the laws determined by the Parliament, there ought to be no role for governments to tell banks how they ought to carry out their commercial functions.

The following material discusses a number of the issues raised in the terms of reference but within the overall framework provided by this preamble.

Competition

Everything in an economy should be thought of as a substitute for something else. Competition between banks and non-banks are a continuum between al forms of commercial practice.

In essence, banks provide a structure between two forms of service:

- places in which those who earn incomes may save
- places from which those who wish to spend more then they have earned in the present are able to borrow, which may be either businesses or private citizens.

Banks compete with the providers of all other goods and services for the nation's resource base (capital and labour). Banks are not the size they are because it has been pre-ordained by anyone. It is the result of the unfolding of the economy over time that has created the structures that we see.

There is something natural and evolutionary in market based economic change. The outcome we find is the way in which things have unfolded. It was an answer to the question asked across the economy: where can profits be earned? This is, it turns out, how profits can be earned and this is the least cost, highest productivity outcome given all of the circumstances that exist. Most of those circumstances can never be worked out in advance and are known to us only because that is the way things have turned out.

The competition that exists between the banking sector and all other sectors and then the competition within the sector itself is the means by which a community ensures that its resources are being used in the most productive ways.

Products and Fees

The banking system is continually evolving in response to commercial needs and the regulatory environment. The major drivers of this evolution are innovation, technological change and relative costs.

We see evidence of this at every turn: ATMs, phone banking, internet banking, secure web payment systems. All have come into existence because the industry has recognised commercial possibilities based on new technologies that have become available.

Governments have nothing to offer in regard to innovation. They can only distort by offering a risk-free or risk-diminished service by underwriting losses that occur in the commercial world. There may be good social purposes that are being achieved in such an approach but there are also certain offsetting social losses that occur as well.

Governments can only do harm by involving themselves in fee setting and oversight. Competition between the banks is the best guarantee that charges will be kept lower than through any other process.

Drivers of Innovative Change

The constant driver is the desire to make profits and to maintain profitability in the face of competitive forces in the market. This is achieved by (i) offering a service that

will attract more customers (ii) lowering the cost of providing existing services or (iii) providing new services that attract a customer base large enough to cover all of the additional costs.

There are dangers in financial markets when innovations arise that attract capital into particular forms of investment where the risks are greatly underestimated. There has been a long history of such innovation from the South Sea Bubble right through to the present where new approaches have caused market participants to misread the potential for loss.

Appendix 1 is a review of *The Big Short*, Michael Lewis's book dealing with the causes of the Global Financial Crisis. This review was published in the July-August 2010 *Quadrant* under the title, "Those Dangled Carrots".

There are a number of lessons that Lewis's analysis directs attention to, but the crucial one may have been the inability of risk rating agencies to properly assess the risks involved in the new forms of Collateral Debt Obligations. That these CDOs were purchased round the world by banking institutions indicates that even the most sophisticated banking minds are not always able to properly understand the innovations that develop within the financial system.

As the article indicates, there was no intent to defraud. The intent was, if anything, to provide finance for low income people to purchase homes. That the market collapsed and almost created a worldwide banking catastrophe was due mainly to circumstance and not due to malicious intent. This is, unfortunately, the nature of the financial system.

Ease of Movement

Banks want to keep all existing customers while attracting customers away from others. Customers at the same time want to get the best deal.

There are costs involved with arranging a loan and ensuring that the borrower is likely to repay. There are establishment costs for the banks that are a necessary part of the process.

It is possible for a government to impose from above a reduction in the charges made by banks just as a government can impose any other price ceiling.

The most basic reason not to involve itself is that by doing so the implications is that governments can adjust market prices if there is enough political desire for such adjustments. It is a trap that no government wishes to fall into. The firmest principle should be that governments do not involve themselves in the pricing decisions of private sector firms.

In this instance, if the government does decide that it will demand that the banks lower charges associated with leaving one lender to take up a loan with another, the

certainty is that the market will respond. There are obvious costs that each financial institution will need to take into account, and if one of those costs is that other financial institutions would be willing to take away customers whose ability to repay has been assessed by a financial institution, then the free ridering will be compensated through other adjustments made to other parts of the financial system.

It is, for example, possible that such costs will be made up front so that the costs to a borrower will increase as financial institutions find that their customer base has been depleted by the activities of competing lending institutions. There will also be an increased reluctance to provide credit so that the actual flow of funds into the housing industry will diminish.

The costs to borrowers will be hidden but if banks are to find their revenues diminished as their customers more easily go to other lenders just as the customers of other banks more easily come to it, the effect will either be a smaller industry and higher costs to borrowers. But as there will be no additional funds in the market place, it is difficult to see how depriving lenders of a relatively stable asset portfolio can improve lending conditions for borrowers in general.

Too Big To Fail

There ought to be no such thing as too big to fail. Once such a designation is given to any institution it has for all practical purposes been nationalised. The moral hazard of such an arrangement is also immense.

Financial institutions are, however, amongst the most important elements of a stable economy. Failure is a constant possibility since the underlying financial system is in continuous change and a severe economic downturn remains an ever-present possibility.

But the system must be regulated in ways that keep those who manage and make use of our financial institutions eternally vigilant and this can only be done if the penalties for failure are constant and personal.

There needs to be a sharing of the risks of failure amongst all of the interested parties. I suggest something like the following but this is only a stylised structure and the proportions are offered without much conviction:

- providers of capital 50%
- bank management 25%
- customers 15%
- government 10%

The example of AIG in the United States during the GFC as discussed in Appendix 1 is quite enlightening. It is almost impossible to see how any change in the institutional structure could have prevented the meltdown. No regulator, no shareholder, no diligence by upper management could have prevented what was essentially a

commitment of the firms capital to underwriting the various debt obligations it had taken on. It was the novelty of the situation that led to the eventual catastrophic outcome.

The lessons of the GFC is one that suggests that if governments are going to keep bailing institutions out almost without cost to those institutions, then the moral hazard will expand. There will be more risky operations run since the penalties of failure appear minimal in the long run.

It is up to governments to recognise that they must make those responsible for the management of failing financial institutions experience a personal financial loss.

Regulation

There is no question that there is a need for protection from fraud and deceit. There is also a need to protect the community from imprudent actions by those who manage financial institutions since for bank customers generally it is almost impossible to inform themselves of all they need to know about the risks being taken on by the financial institution in which they save.

Criminality must be framed in terms of offering a product that the seller knows will not provide a positive return or in which the risks are concealed or exaggerated claims are made. There is a need to limit the possibilities of excessive risk taking outside the framework permitted by financial institution licensing.

But where regulation should play no part is in determining for financial institutions the interest rates that are set on funds borrowed. The availability of capital is a market determined process that is at the very heart of the financial system. Ensuring that such funds are borrowed and lent at market determined rates of interest is a crucial aspect in ensuring that our savings are used in the most productive way.

There is no reason to believe that the financial system has been unable to channel savings towards borrowers efficiently. The financial system is sufficiently open, and there are many institutions both large and small that could expand their operations were there a serious flaw in the market, that would allow a lower cost allocation of savings to those who would make the best use of those savings. There has been, to my knowledge, no convincing evidence of such inefficiencies at the present time.

There are always rigidities of various kinds in a market but these are ironed out over time by competitive forces. There are four large banks and a number of smaller banks. Banking licences can be granted if various tests can be passed by applicants.

But there is nothing in the way in which funds are allocated that suggests that legislative change would be likely to open new sources of funds and lower the cost of borrowing to those who seek access to our available capital resources.

Cost of Capital

There would not even be a Senate inquiry had the banks simply passed on no more than the 0.25% adjustment made by the RBA. It was that the banks raised their rates by more than that percent that has made this such a major political issue.

Banks are a mediator between savers and borrowers. The difficulty in gaining access to savings in the post-GFC environment has been exacerbated by the demand for funds through the Federal Government's stimulus program. The stimulus has absorbed immense amounts of capital which must ultimately raise the cost of finance, particularly when other sectors of the economy, and in particular the mining sector, begins to seek additional capital resources.

Attached as appendixes are two articles that were written dealing with the cost of capital, interest rates and saving in Australia.

The first of these articles, "Government Spending and Rising Rates of Interest" (Appendix 2), was published in the *Australian Financial Review* on 4 November 2010. The final paragraph sums up the point made:

> "If you don't like higher interest rates, there is no point in blaming the RBA or for that matter the private banks. It is the government that is absorbing our national savings and raising the cost of capital. So long as it continues to do so, the pressure on rates will remain."

The RBA has itself been at pains to argue that it expected the banks to raise their rates beyond the RBA's adjustment and understood why this was necessary. The cost of funds for the banking system was rising and had to be reflected in the rates charged by the banks.

The second article which has not yet been published is titled: "A Wicksellian Monetary Policy" (Appendix 3). It makes the same point but in a more technical way. The term "Wicksellian" refers to the nineteenth century Swedish economist, Knut Wicksell, whose views remain as one of the most important insights on monetary policy. The following is a quote from RBA Governor, Glenn Stevens, on the value of Wicksell in making sense of monetary policy, savings and rates of interest.

> "For what it is worth, I think that the Wicksellian notion of the natural rate of return on capital, the market interest rate and the dynamics set in train by the differences between those two rates is one of the more useful analytical devices for understanding the modern economy with a private credit system."

The core point is that as real savings are used by governments, the rate of interest must rise for the rest of the community. The economic problems that arise where interest rates do not rise to a sufficient extent are precisely the kinds of problems that have arisen both in Australia and overseas. As noted in the article:

> "Excess demand for real saving leads to asset bubbles, underperforming investments, inflation and slower growth. The banking system allocates its savings towards less risky borrowers since lower rates attract far more demand than the available supply.
>
> "We also find that the more adventurous and potentially more productive forms of investment are ignored by lenders as they choose the safest borrowers to place savings with, even though these more adventurous investments are the kinds of investment that, over time, lead to the fastest growth and the largest increases in living standards.
>
> "It all comes down to this. The more that governments use up our savings, the fewer savings available for private sector use. The more that savings are directed by governments, the higher the natural rate becomes."

Failure to recognise the effect on domestic rates caused by government spending results in financial decisions that are economically suboptimal. It was this process that contributed to the Global Financial Crisis in the first place.

Conclusion and Recommendations

The conclusion of this submission is that there is no reason to change the regulatory regime in the financial system at this time because of the movements in private sector determined interest rates within the banking system. Indeed, if anything, the fact that the banking system has been willing to accept populist criticism in raising rates beyond the rate adjustment made by the RBA should be seen as a positive feature.

It is important that interest rate determination is based on supply and demand conditions for finance. Raising rates helps ensure that savings are properly allocated to their highest valued use. In an economic environment where governments have increased their level of spending by running large deficits and where capital is scarce because savings are being taken up by governments in their own spending programs, this approach taken by the banking system is both responsible and appropriate.

There are no doubt other regulations that might benefit the operation of the finance industry and the banking system, but holding rates below their equilibrium level is not one of them.

The recommendations made are:

- it is up to the banking system to adjust rates based on each individual bank's own circumstances as judged by senior management in that bank

- whatever may be the uses made of central bank monetary policy, neither the government nor the RBA should dictate interest rate adjustments to the banking industry

- the government should not seek to subsidise the establishment of new financial enterprises as a means to lower rates since such subsidies will only distort the market and cannot create new savings

- new financial institutions should arise only because of individual market based decisions

- competition within the banking sector should be encouraged so that entry into (and exit from) the industry can take place where profit making opportunities arise

- the government should consider new regulations as circumstances suggest but in so doing recognise that such regulations are a cost to the industry and may lower its performance and reduce Australian productivity growth.

Appendix 1

Those Dangled Carrots

Review of: *The Big Short* by Michael Lewis
Quadrant July-August 2010

The Big Short is Michael Lewis's incredible retelling of the meltdown of the American financial system. What happened, who was responsible and what to do now have been major matters since the subprime disaster. Lewis tells the story from the perspective of those who ended up raking in the millions (and millions) by "shorting" the market for subprime mortgage-backed bonds.

The astonishing merit of the book is that I now know much more about the intricacies of what happened but am less sure than ever about just exactly what it was that anyone could ever have done about it before the fact. While you would like to point your finger and say that there is the villain, so-and-so was corrupt, this one was dishonest or these people over here ought not to have done what they did, there is none of that at all in the way the story is told.

At every stage in the bringing together of mortgages into "collective debt obligations" (CDOs), and then the further creation of a form of insurance known as "credit default swaps" (CDSs) no one was acting other than in a way intended to of course make themselves money but also while offering a financial product they personally believed was providing security and additional financial opportunity to others. Greedy, yes, but what's new? It wasn't greed that drove the process into the ground so much as an absence of a sense of danger.

In particular, no one seems to have had grand larceny on their mind or at least that is the way the story is told. It was only that the big picture and the risks involved eluded virtually everyone in the major bond-trading houses and elsewhere. You can say they were incompetent and ought to have known what they were doing, but like with any tragedy you can look back with the kind of clarity you never have looking forward.

If there was incompetence at the helm, it seems to have been in the ratings agencies. The enormous risks and absence of value in the CDOs, these bundled mortgages, were recognised by that tiny handful of bond traders who could see the disaster in the making and made millions from it. But they were the tiniest minority amongst all of that financial genius that Wall Street is supposedly packed with. The credit rating agencies seemed to have been completely out of their depth in calculating risk.

Explaining What Went On

To understand how everything fell apart, you need to know the meaning of some financial terms and how everything meshed. And I offer my apologies in advance for my poor general understanding of any of this. If you are a financial type, just

remember that I am equally incapable of explaining nuclear physics. But let me give it the old college try.

We begin with the mortgage, a document that states that in exchange for a sum of money used to buy a house, the borrower will repay certain sums of money at stated intervals for a stated period of time until the whole amount borrowed plus interest is paid off.

Next it is necessary to appreciate what is meant by a "teaser rate". This is the very low interest rates that were being offered to house buyers for an initial two year period before the actual interest rate kicked in, with its built in catch up.

A subprime mortgage is an offer of housing finance to people with a poor credit history. Offering to lend to people with lousy credit ratings and a much impaired ability to repay a debt was perhaps asking for trouble, but there you have it, especially with a teaser rate off the top.

There is then what is know as a Collaterlised Debt Obligation (a CDO). This was a bundling together of hundreds of mortgages into a single package that was then sold round the world as a bond. The various mortgages each had a particular cash flow potential so that with all of the embedded mortgages taken together, if everyone kept paying as their payments came due, a potential monthly return of a certain sum of money would result.

So far as the buyers of CDOs were concerned, they would either get the value of the mortgage payment month by month or their owners could sell the house if payments could no longer be made. Since house prices had never fallen in the United States for something like sixty years, there seemed to be no risk whatsoever in buying these bundled together mortgages. They would continue to provide a steady income to those who held the bonds.

And the good thing about the CDO was that all kinds of people could be allowed to buy property where they had been unable to do so before. Even if some of the mortgage owners might default, the law of large numbers meant that most would not – why should the future be different from the past? – so that there would continue to be a steady stream of payments. Therefore money could be poured into financing poor people into houses they could not otherwise have been able to afford.

Now we come to the Credit Default Swap, the CDS. This was a form of insurance on the various CDOs, the bundled together mortgages. They were thus a form of insurance just in case more people than expected ended up defaulting on their loans. What made this a very very unusual form of insurance was that it was insurance on something one did not own, like buying fire insurance on your neighbour's house.

This is how Lewis describes the process as seen by Michael Burry, the financial innovator who worked out how to make money shorting the subprime market:

> "The various floors, or tranches, of subprime mortgage bonds all had on thing in common: The bonds were impossible to sell short. To sell a stock or bond short, you needed to borrow it, and these tranches of mortgage bonds were tiny and impossible to find. You could buy them or not buy them, but you couldn't explicitly bet against them; the market for subprime mortgages simply had no place for people in it who took a dim view of them."

But where there's a will there's a way. Lewis explains how Burry solved this problem having discovered the CDS a few years earlier:

> "[The CDS] was an insurance policy, typically on a corporate bond, with semiannual premium payments and a fixed term. For instance, you might pay $200,000 a year to buy a ten-year credit default swap on $100 million in General Electric bonds. The most you could lose was $2 million. The most you could make was $100 million, *if General Electric defaulted on its debt any time in the next ten years and bondholders recovered nothing*." (My italics)

So if you thought that subprime bonds would actually default, not just fall in value but actually default, this was how to do it.

The question then was how much should this insurance cost? How much should an issuer of a CDS charge for insuring the holders of the bundled mortgages? That, of course, depends entirely on the size of the risk. If your house has a one in ten probability of burning down, then the insurance will be somewhere above one tenth of the value of your house. Actuarial risk is built around the probability of an event taking place and the payout that would be required if that event should actually occur.

Therefore, the crucial question was making sure that the estimated risk would coincide with the actual risk. That is what insurance companies do, and here the issuers of the CDSs depended on the ratings agencies to estimate the risk correctly. Underestimating the risk would jeopardise the entire process since the CDSs would be priced well below a level needed to compensate for the risks involved.

So the question before the ratings agencies was how much risk was there in large scale defaults on mortgages. As the ratings agencies saw it, building on their knowledge of the past, the question was how likely would it be that an event that had never happened would happen. To them, it was as close to zero as could be imagined.

Meanwhile, there were a handful of investors in pockets around the US who could see only trouble ahead for the CDOs, the bundles of mortgages. They recognised that the kinds of people who were buying houses under these new terms were not your solid middle class citizens but were an entirely new segment of the market who had never previously owned homes. Moreover, they took the view that when the teaser rates had finally come to their end after two years, whatever financial stress that had existed before would become unendurable. The rate of default would therefore explode.

So what they did was go around buying as many of the CDSs as they could afford. Since the ratings agencies had examined in their lackadaisical way the various mortgage bundles, and had given them highly inflated credit ratings (Triple-A and all that), the cost of the insurance were miles below the risk, a few cents in the dollar.

In buying such insurance, to use the parlance of the financial world, they had "shorted" the market by betting against their solvency; that is, they bet that the value of all of these CDOs would disappear up in smoke.

So when the defaults did indeed begin, all those who had bet against the solvency of those holding the mortgages reaped hundreds of millions from the financial system. The insurance companies who had issued the CDSs were suddenly required to cough up immense amounts of capital at short notice, capital they did not have.

And who held all these CDSs. This is where the insurance giant AIG found itself facing bankruptcy along with others since there was no possibility for any of these insurers to pay off anything like the money owed.

Meanwhile, major historic financial institutions, whose CEOs and directors had had no idea of what was going on in their normally placid bond departments, discovered almost overnight that they had been exposed to risks of which they had no idea. These CDOs, which existed in the billions of dollars, but which now appeared worthless, would drag them into oblivion.

Moreover, these CDOs had been sold off around the world and were part of the asset portfolio of financial institutions and pension funds everywhere. The more of these "toxic assets" these institutions held, the more the asset base of these financial institutions disintegrated before their eyes. The entire financial system of the world therefore froze since no one could any longer be sure that any single financial firm across the entire globe was actually solvent and could guarantee its debts.

It was at this point that the Bush administration came up with the Troubled Asset Relief Program (TARP) to refinance the losses of these major Wall Street institutions along with the insurance companies who were required to pay out on the CDSs they had issued. And according to Lewis, they did it for free with no strings attached. They just gave them all the money they needed to cover their debts and so here we are. Or so at least I understand.

What to Do

In reading Lewis and the story he tells, it is hard to know how any of this could have been avoided. If industry professionals cannot work it out ahead when it's their own money on the line, no one else can either.

What becomes pretty clear is that no regulator would have made the slightest difference. If the risks eluded even those with an enormous financial interest in getting it right, there is next to no probability any regulator would have unscrambled

that egg. Anyone with the ability to have understood what was going on would have stood to make his fortune rather than working for a regulatory agency. No such persons exist.

Those who had argued that such CDOs, rather than spreading risk which was what they were designed to do, had actually concentrated risk, were proven right. In an opposite way, those who had thought that CDOs were a good way to provide finance to the less well off were *perhaps* proven wrong while others who had said that the government should not be trying to foist loans on people on low incomes were *perhaps* proven right. Starter rates seem to work all right in Australia and elsewhere if they are given to people who don't need them. Otherwise, forget it. They are a trap for the unwary and can ruin lives.

A market system works only if the costs of production are paid for in the prices received, with bankruptcy the normal way to deal with those who miscalculate. That works for most markets and I cannot think why it should not work in finance just as well.

Therefore, if I found a policy message it was this. In such a high stakes business accountability matters. Limited liability in brokerage and other areas of wheeler-dealer is a poor idea. It should be partnerships or nothing. The lazy absence within these major Wall Street firms of real effort to understand what was being done finally unraveled. But those who have paid with the jobs and their homes are not the ones who brought this catastrophe down on our heads. Unlimited liability would make sure they paid attention and if they messed up that they paid with their wealth.

But in saying any of this I go past my expertise. There are no doubt ways to institutionalise arrangements so that this particular disaster never recurs. But given the nature of the story, there are other financial geniuses who will find some other way to finagle their fortunes out of misperceived and mispriced risk. But this observation made by one of the traders who earned tens of millions on the meltdown does appeal to me:

> "If you are going to start a regulatory regime from scratch, you'd design it to protect middle- and lower-middle-income people, because the opportunity for them to get ripped off was so high. Instead what we had was a regime where those were the people who were protected the least."

Recessions are periods of renewal when an economy rights itself from whatever misdirection there had previously been. The story of the Global Financial Crisis is one more example of a general case. How to stop them from happening no one knows. The business cycle will be with us forever.

What we can stop, however, are the Keynesian methods of dealing with recessions. The TARP and other such emergency arrangements did seem to bring the rot to an end. The problems in the US economy is no longer found in the financial system but in the insane levels of government spending and debt that followed from it. It is this

that seems to have brought longer term ruin to the world's economies rather than the financial panics.

As for the underlying human nature that drove the subprime crisis, I take you to the last two sentences in the book: "Something for nothing. It never loses its charm." Yes, as the book tells the story the fatal attraction of the free lunch is ever present, whether on Wall Street in putting together these bundles of debt or amongst those who borrow to buy houses using a low interest subprime mortgage. Those dangled carrots. Who can ever resist?

Appendix 2

Government Spending and Rising Rates of Interest

It was pleasing to see the RBA raise interest rates, and the economy will be all the better for it as well.

The trouble with all that free stuff governments like to give out is that it isn't really free after all. The true cost of government spending comes out of our collective wealth in a process almost invisible to the naked eye, with the frequent aim of governments to keep it as invisible as possible.

Australia is amongst the few economies where official interest rates have been rising. Nor is it a coincidence that the Australian economy has been amongst the better performing economies of the world. Raising rates has been an essential part of the reason why the economy has performed as well as it has. It is a cause as well as a consequence of our relative economic success.

The rate of interest is the price paid for resources made available for investment. When people save, they may think what they are saving is money but this is in many ways an illusion. They have produced goods and services, received an income for their efforts but chose not to buy everything their income would have allowed them to buy. Unspent income is saving, and to the individual saver these savings come in the form of money.

But that is to look at things from the perspective of the individual saver. From the economy's perspective what savers do is leave for others the goods and services they had produced but did not themselves consume.

They have transferred to others, for a price, the right to use the output that has been made available by their decisions not to immediately buy as much as their incomes would have enabled them to.

They have postponed their own purchases until a later date but in doing so have provided an opportunity for others to make use of those unused resources to build productive assets through investment programs of their own.

Without saving there can be no investment. All investment is the product of saving and however much or little there is, you cannot invest more than what you have saved.

But it is not just private firms who seek access to these savings. Governments, too, absorb huge amounts, taking these in as tax revenues and then borrowing more to finance projects of their own.

Rising rates are a reflection of the supply and demand conditions for private savings. What's left after the government has taken what resources it has decided to use up is what's left for the private sector to divide amongst itself.

The advantage the government has in getting its hands on the savings of a nation is that when it borrows lenders know they will get their money back, governments get to print money when they cannot borrow all they want, and they can run deficits without immediate concerns about where the money to repay their debts will be coming from.

But here is the trick. Borrowing almost invariably comes in the form of money. A nation's real savings, on the other hand, come in the form of actual resources which can be applied in building investment projects.

Of money there is an almost endless supply. There is as much as a government is prepared to create.

As to the availability of underlying real resources, the supply is finite and strictly limited. The core task for a central bank is to make sure the flow of dollars entering an economy is matched by an available flow of real resources the money can be used to buy.

Too much money relative to the resource base of an economy and we have inflation. It is this the RBA is determined to stop.

Interest rates are rising because the government is using resources even before they reach the private sector. The government may be able to provide school halls, install insulation and now the NBN. But if you think you are getting all this for free, you should think again.

The RBA is continuing to raise rates because the government is taking up domestic savings more rapidly than we are able to generate those savings through productive activity.

In this economy at this time it is the government that is the single most important cause of rising rates. The RBA is only doing what it can to ensure the resources available for investment are properly priced.

The pressure on rates therefore remains upwards and will continue to remain upwards so long as the government continues its relentless take up of our productive resources.

But if you don't like higher interest rates, there is no point in blaming the RBA or for that matter the private banks. It is the government that is absorbing our national savings and raising the cost of capital. So long as it continues to do so, the pressure on rates will remain.

Appendix 3

A Wicksellian Monetary Policy

Australia really does have a different kind of monetary policy and it more than just because we are raising rates when no one else is.

Just how different policy in Australia is can be gleaned from the published text of a speech given by the Governor of the Reserve Bank, Glenn Stevens, at the University of Sydney on 15 May 2008. Amongst the footnotes to this speech, which undoubtedly means these words were never actually said out loud on the night, was the following:

> "For what it is worth, I think that the Wicksellian notion of the natural rate of return on capital, the market interest rate and the dynamics set in train by the differences between those two rates is one of the more useful analytical devices for understanding the modern economy with a private credit system."

Having an interest in the history of monetary policy, I was tipped off about this comment after mentioning to someone that policy in Australia no longer looks like the inflation targeting of old and now looks a lot more like Wicksell than Keynes. And might I say that if this is indeed the case, our monetary policy has become about as good as it gets anywhere in the world.

But to understand why this is, it is necessary to appreciate the approach devised by the great nineteenth century Swedish economist, Knut Wicksell.

According to Wicksell, there are two interest rates, one visible and the other almost totally invisible. The visible rate of interest is the number found in every central bank publication, is prominently displayed in every trading bank and is generally recognised as the price of credit.

If you want to borrow, this rate, the market rate of interest, is the amount you pay.

There is then the invisible "natural" rate of interest, what Glenn Stevens referred to as "the natural rate of return on capital". This is the rate that brings the demand for savings into equilibrium with the supply of savings. It is the price of real capital – actual productive resources – available for use by the private sector.

The rate that is manipulated by central banks is the nominal rate. And the question is whether the natural rate, that hidden rate that allocates actual real capital, is higher than, the same as or lower than the nominal rate.

The problem facing a central bank is that if the nominal rate is lower than the natural rate – which is what monetary policy often attempts to do – the outcome is excess demand for the available savings of an economy. The consequences then are all of the kinds of things a central bank is supposed to protect an economy from.

Excess demand for real saving leads to asset bubbles, underperforming investments, inflation and slower growth. The banking system allocates its savings towards less risky borrowers since lower rates attract far more demand than the available supply.

We also find that the more adventurous and potentially more productive forms of investment are ignored by lenders as they choose the safest borrowers to place savings with, even though these more adventurous investments are the kinds of investment that, over time, lead to the fastest growth and the largest increases in living standards.

It all comes down to this. The more that governments use up our savings, the fewer savings available for private sector use. The more that savings are directed by governments, the higher the natural rate becomes.

The RBA, if it is actually taking a Wicksellian approach, is raising rates to reflect the lower volume of real savings available to business.

Such increases in interest rates do not, may it be noted, solve the problems that come from governments wasting our resources. But what they do achieve is to bring the government's cost of borrowing closer to the true cost.

Meanwhile, those keeping rates lower than the natural rate create ongoing problems of which asset bubbles are the most visible but not necessarily even the most damaging.

Rising interest rates are part of what has kept the Australian economy on an upwards trend since the GFC began, in the same way that artificially lower rates may have caused, and with QE2 will continue to cause, immense damage to the economy of the United States.