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WHAT ARE THE REASONS FOR AND AGAINST OFFICIAL SUPERVISION OF FINANCIAL INSTITUTIONS?

WHAT ARE THE ADVANTAGES AND DISADVANTAGES OF REPLACING THE CURRENT COMMONWEALTH SUPERVISORY SYSTEM WITH A SINGLE REGULATOR?

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DAVID WILLIAM SPAIN
B.A. LL.B. (Hons.)

Student Number 227976940

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5. **CONCLUSION**

PART A.
WHAT ARE THE REASONS FOR AND AGAINST OFFICIAL SUPERVISION OF FINANCIAL INSTITUTIONS?

#1. INTRODUCTION

Financial Institutions ["FIs"][1] play a vital role in advanced free-enterprise civilizations, but money, the commodity in which they deal, is essentially no different from any other commodity and it does not justify the extensive & unique official supervision imposed. Whilst many traditional regulations have been removed as unproductive and some aspects of the remaining supervision are appropriate public interventions, the majority (especially those against Deposit-Taking FIs ["**DTFIs**"]) are either useless or counter-productive (actually fostering the problems they purport to prevent). The lingering monetarist motivation and "Lender of Last Resort" ["**LOLR**"] rationalization behind supervision is inherently suspect.

Free trade in money is as desirable as free trade in anything else, but it will only be viable when the two great monopolies gnawing at the heart of advanced civilizations are dissolved. These are State monopoly upon creating money and Land Monopoly, whereby owners of sites profit (without necessary contribution or accounting) from public betterment (via infrastructural expenditure, population growth etc.) of those sites.

There is a third area of reform which should focus on the FI sector: this relates to enhancing the responsibility of owners (who are only exposed to the extent of their shareholding) and of managers (who tend to imprudently pursue growth in the name of empire & commissions). In order to tighten corporate self-responsibility in the FI sector, it would be wise, by legislation, to expose all FI shareholders to a "second tranche" of personal liability (should their institution fail) equal to capital invested. There is wisdom, too, in requiring all management salaries to be paid (over & above a survival sum) in future options for the company's shares.

Given those reforms, prudential self-regulation would be promoted and the vast bulk of current official supervision over FIs would be superfluous. Supervision related to informational symmetry would, however, remain appropriate. This remnant could continue to be administered by a single authority (the ASC) since the only common theme is information disclosure.

#2. REASONS FOR OFFICIAL SUPERVISION OF FINANCIAL INSTITUTIONS

(a) Economic Importance of Financial Institutions ["FIs"]

FIs perform a valuable role in the economy by providing "safe havens" for cash deposits & loans, and by acting as intermediaries transforming the risk & liquidity structure of assets (quantum, maturity dates, interest rates, etc.) to match the respective needs of lenders & borrowers. Loans are then secured by a variety of instruments which are then themselves tradable in the secondary market. FIs take advantage of scale economies to minimize transaction costs and can absorb & synthesise data far more efficiently than isolated individuals. Transformation can spread & diversify risk by assembling portfolios and trading in derivatives.

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[1] The Australian financial system has five main categories: the central bank, banks, non-bank FIs, insurance & superannuation FIs and the securities industry.

FIs thus foster the efficiency of capital and enhance productivity, and their healthy operation is seen by government as vital to the national economy.

(b) Perceived Risks in FI Operation

Liquid cash held by FIs is usually only 5-8% of deposits taken. The balance of an FI's non-physical assets are securities, both equity (e.g. stocks, shares, trust units) & debt (e.g. mortgages, bills of sale, charges), and financial instruments (e.g. bonds, bills, futures & options), which cannot be liquidated until mature.

This operation on a fractional reserve raises the traditional fear[2] that excessive withdrawals of deposits from a bank (even an inherently healthy one) could cripple its liquidity and force its collapse. Resulting panic could spread "by contagion" sparking "runs" on other banks, undermining the entire sector. Certainly there have been major runs on banks, e.g. in Australia during the 1890's and in the USA during the early 1930's[3], however it is important to note that, arguably, the

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2 "The solvency of any banking system depends ultimately upon the ability of banks to repay their deposits as they fall due. The failure of one bank to meet demands for the repayment of its deposits, even though it may have ample assets with which to meet its liabilities if allowed time, may bring about a condition which may seriously threaten the stability of the whole system. For that reason, it would appear to be the responsibility of the central bank to consider whether the actions of any bank are in conformity with the general interest. ....

If, in the opinion of the Board of the (central bank), a bank is acting in such a manner as to endanger the whole system, it may be the duty of the Board to intervene and to point out to those in control the possible consequences of their actions. It is probable that this would be sufficient, but if it were not it might be necessary for the (central bank) to exercise some of its powers to make it difficult or impossible for the offending institution to continue the course to which objection was taken. ...

Each case must, however, be decided upon consideration of the circumstances, and it is impossible to lay down any general rule. We desire to emphasise the point that our system is made with the object of safeguarding the banking system as a whole. In our opinion, this can best be achieved by providing the utmost security for depositors. We are not concerned with the interests of shareholders as it is within their power to safeguard their own interests. The failure of any business other than a bank affects mainly those directly interested and does not threaten the banking system. We do not, therefore, suggest that the (central bank) should intervene except in the case of a bank. "

-- Royal Commission on Monetary and Banking Systems, 1937, "Prevention of Bank Failures", pp 235-7.

3 High interest rates were introduced by regulation in 1929, so as to curb loans fueling the frenzy of speculative activity which gripped the New York Stock Exchange from 1927-29. This pricked the speculative bubble and precipitated the 1929 "Crash" in share prices. After the Crash deposits with banks initially increased as investors sought liquidity & security: deposits were 5-7 times capital and credit terms were easy.

However, many unwise loans had been made during the speculative boom, often on a nepotistic basis and without prudential investigation. These loans tended to be applied to stock market and real estate speculation. From mid-1930 diminishing commodity prices (30% in agricultural products, 35% in industrial commodities) led to repayment defaults which were inadequately secured due to a 30% drop in price of mortgaged land. Deposits dried up (especially at small & country banks outside the Federal Reserve System) and numerous bank runs occurred.

In 1930 some 1350 banks suspended operation and the bank of United States collapsed in December, despite efforts by the Federal reserve to prop it up by buying stock, with its share price at $3.00 from a 1929 peak of $243. The federal reserve did not act as lender of last resort to any banks, nor indicated that it was responsible to guarantee or preserve the credit of the banking system. By 1932 massive Reserve loans were being made to prop up banks but deposits continued to decline, funds were withdrawn & hoarded, loans were cut and the liquidity squeeze on banks became acute so that by late 1932 banks were shutting on a statewide basis, reducing bank numbers from 25,000 in 1929 to 14,000. It was election time, and Roosevelt blamed financial incipient speculative conditions underlying the 1929 Crash could not have existed without land monopoly, and that it was official monetary interference (setting artificial interest rates and blocking liquidity) and anti-branching rules which actually crystallized the crisis.

Extrapolating from this fear of single or multiple bank runs, regulators also argue that it is also important for public confidence in the financial system as a whole that each bank can meet calls to liquidate deposits, and that the interbank payments system operate smoothly. Panic, they say, could not only damage one significant institution or unleash a "domino effect" undermining banks generally, but indeed create havoc in the national economy. Crippled liquidity would force interest rates to soar and restrict credit, inducing a depression and destroying public faith in the national financial system.

On a more microeconomic level, regulators argue that uncontracted risk properly merits official supervision since an FI failure impacts "small, innocent & unsophisticated" depositors & counterparties who are neither owners nor managers of the FI. Certainly management of any FI is in a much better position to assess its viability than depositors, especially as most assets of FIs are not traded on secondary markets and hence subject to monitoring. However, depositors should reasonably be aware that there is some risk[4] involved in any deposit, and education could enhance this. There would be no problem with establishing no-risk, low or no-yield institutions (such as the government-guaranteed Commonwealth Bank or the European Giro system) to cater for strongly risk-averse depositors.

Regulation & Deregulation since 1937

From 1938 a maze of petty market restrictions on DTFIs[5], implemented by the Reserve Bank of Australia ["RBA"], pursued monetary rather than prudential policy, however they ensured that the bulk of bank assets were low-risk thus protecting depositors anyway. These regulations encouraged evasion and distorted market behaviour so that the bank sector lost importance to NBFIs, which were not amenable vehicles for government monetary policy.

Against a background of global computerization & innovation, major reports into the financial system[6] recognized that deregulation was essential, and from 1984 many petty market constraints were gradually removed to maximize efficiency, competitiveness & stability[7]. However

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abuses for the crash and the bank collapses, promising stiff regulation.

See: Barry A. Wigmore *The Crash and its Aftermath A History of the Securities Markets of the United States*, 1929-1933; Greenwood Press, Connecticut (1985) Chapter 4 & 10.

4 When transforming assets, DTFIs (and FIs generally) are inevitably exposed to risk. This exposure may be operational (negligence or fraud by management), or triggered by borrower defaults ("credit risk"), fall in the price & yield of assets, unexpected withdrawals, fluctuations in exchange rates, crystallization of contingent liabilities (e.g. guarantees), or failure of an associate in a conglomerate. Risk exposure must be monitored and reduced by diversification (geographically & industrially), hedging and securitization.

5 These were implemented after the Report of the Royal Commission into Monetary & Banking Systems (1937), whose recommendations are reflected in Division II of the *Banking Act*. They fixed exchange & interest rates, specified portfolios, capped loan ceilings and required a proportion of liabilities (the Statutory Reserve Deposit ["SRD"]) to be lodged with the Reserve Bank and others to be held.

6 The Campbell Committee reported in 1981 in Final Report of the Committee of Inquiry into the Australian Financial System AGPS. It was followed by the Martin Report in Feb. 1984.

7 E.G. The changes lifted caps on deposit & lending rates, floated foreign exchange, deregulated mortgage rates, allowed entry of new banks, replaced LGS with PAR, replaced SRD with capital adequacy, and formed AFIC.

traditional fears persisted and "persuasive not prescriptive" prudential supervision over DTFIs and the LOLR role (which fell short of a guarantee to depositors) were retained, whilst tougher prospectus requirements & disclosure rules for all FIs were adopted. The "monetary policy" mentality also persisted, ostensibly to promote macroeconomic stability (in employment, prices, sustainable growth, inflation etc.) as a legitimate goal. However, now it operated through the market rather than banks, enabling government manipulation of relative costs & availability of funds in the community.

In hindsight, adjustment to deregulation was slow and the cost high.[8] However, the effort was worthwhile[9]. Implementation of the "persuasion not prescription" approach proceeded, with prime reliance upon prudent self-management and co-operation with RBA advice.[10]

Actual Controls on DTFIs

Banks come under the control of the Reserve Bank of Australia, whilst Non-Bank Deposit-Taking Financial Institutions ["NBDTFIs"], such as building societies and credit unions, are now controlled by the Australian Financial Institutions Commission ["**AFIC**"]. In each instance prudential controls include minimum (risk-weighted) capital & liquidity requirements, controls over shareholding, the reporting of large exposures, the segregation of funds-management activities and external auditing. In theory RBA operates by persuasion not prescription, and stands behind each bank as a LOLR, although not as a formal guarantor[11]. A general feeling and public expectation has been

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8 Rapid expansion of credit & asset prices, extensive bad debts, foreign currency losses and massive Current Account Deficits were not foreseen. Competition between established banks was slow to grow, but they did begin to regain market share from NBFIs.

9 In October 1990 another Martin Committee reported:

"There should be no winding back of the deregulatory changes that have occurred ... A major role exists in a deregulated environment for governments to ensure that markets work efficiently and competitively and that the financial system remains safe and sound. The role of government intervention lies in ensuring an adequate information flow to consumers. There is also a role in ensuring that monopoly control and competition is strengthened. Finally, government intervention is essential to ensure an appropriate system of prudential control". House of Representatives Standing Committee on Finance and Public Administration 1991, pp. 458-9.

10 Communicated through Prudential Statements (which are flexibly amended on an ad hoc basis as experience evolves) covering such matters as defining capital, imposing a capital adequacy ratio, restricting bank ownership, requiring regular detailed statistical returns, guiding bank relations with NBFIs, NBFI access via bank agency to the payments system, replacing LGS with a 12% prime assets ratio ["PAR"], reporting requirements for off-balance sheet activity & "large" credit exposures, external auditing of prudential compliance & statistical accuracy, risk-based capital adequacy guidelines and deduction from capital of equity in subsidiaries. The RBA (unlike the U.S. Federal Reserve) still does no direct on-site inspections or examinations: these might impose additional disciplines and better acquaint RBA with operating procedures, but they are costly and would enable shedding of responsibility.

11 RBA showed itself as willing to perform this role during the irrational (sparked by malicious rumours) 1990 run on Metway Bank in Brisbane. However, in no other Australian instance has it been put to the test. With the Bank of Adelaide in 1977, a merger was arranged. Shareholders got 3 shares for every 8 and did better than they deserved, but they did suffer a substantial capital loss. In the instance of State Bank of Victoria, whose finance arm the merchant bank Tricontinental collapsed under pressure of bad debts, the moribund bank was merged with the CBA, but only after Victorian taxpayers met some of the debts. There were no private shareholders. SBV was in clear breach of RBA prudential guidelines but RBA did not detect this. With the State Bank of South Australia, there was no real owner's capital and no merger was available so taxpayers of that state, as (effectively) compulsory shareholders, have become obligated to pay its debts via higher State taxes indefinitely. The irate taxpayers decimated the Bannon government at the next elections. With the Farrow Mortgage Corporation, the Victorian Government had made the mistake of

induced that most banks (certainly the big four) are "too big to fail".

Regulation of Markets & Dealers

Regulators' concerns extend beyond the "protection" of depositors and the prudence of DTFIs to the market and its operators, which are so vital for transformations to occur safely & reliably. The 1969 Poseidon scandal[12] and the 1987 share market crash exposed serious deficiencies in Australian regulation of the securities industry, highlighting the complexity & diversity of the modern economy, whose stability & health depends upon constant and reliable communication between units.

Markets play vital role in the economy since they cater for symmetric risk, where few (if any) unknown variables pertain, and oust satisficing so as to provide an efficient governance mechanism both allocatively (in that resources are allocated to the highest bidder) & operationally (in terms of running cost overheads). They disseminate information and broadcast prices, rates & yields: this promotes certainty in trading & financing and allows ex post adjustments as the ongoing market digests & balances information.

If the integrity of markets is to be preserved, it is in the public interest that extensive disclosure and responsibility prescriptions apply. These are now contained, by inter-state agreement, in legislation[13] with a view to maintaining, facilitating and improving the performance of companies[14] & markets (including Futures markets[15]), achieving commercial certainty and maintaining investor confidence[16]

This legislation defines "securities"[17] widely as including all kinds of commercial paper such as debentures, bonds, unit trusts and stocks as well as shares, but it excludes futures contracts. It regulates the formation & operation of stock exchanges[18], licenses securities dealers,

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saying (during initial queasiness) that the deposits were safe. When the run eventuated and culminated in collapse, the Government allowed itself to be politically trapped into guaranteeing the deposits 100%: rather a foolish & unnecessary move since the depositors were really in a high-risk, high-yield institution of their own volition. It is important to note that these collapses basically occurred because the security for loans proved inadequate when land prices dropped after the "asset-boom" of the late 1980's. No price (above the value of improvements) can attach to land if the rental-value of the site (which was not made by humanity, but whose value is made by society not the siteholder) is collected regularly.

12 See: *Australia's Securities Markets and their Regulation* The report of the Senate Select Committee on Securities and Exchange [Rae Report] AGPS 1974. On 1.10.69 Poseidon NL announced to the Adelaide Stock Exchange that its exploratory drill had struck 30 feet of sulphides assaying 3.56% nickel. The price of its 2.04m issued shares rose, over the next four months, from $1.10 to $280.00. 500,000 of these shares had been placed (largely with companies associated with the directors) after the discovery but before the announcement. Also, insiders purchased bulk shares during that period.

13 Corporations Law (1990) and the Australian Securities Commission Act (1989).

14 The ASC has no power over some FIs, such as those incorporated under specific State Acts, building societies & credit unions and unincorporated trusts.

15 S.148 *Australian Securities Commission Act* (Cth) 1989.

16 See *Australian Securities Commission Act* (1989) s. 1(2).

17 *Corporations Law* s.92.

18 *Corporations Law* Part 7.219. Ibid Part 7.3.

underwriters and advisers on capital-raising and investment[19], establishes compensation funds for those caused loss by improper securities dealings[20], and regulates the proffering & transfer of securities[21]. ASC operatives with conflicts of interest, or who become privy to sensitive information, bear strict obligations[22].

However, beyond these controls to "keep the game clean", the Australian government does not interfere in the private enterprise transformation process by dictating forms of instruments, portfolio mixes, interest rates etc. Commercial decisions are left to the FIs involved and they are allowed to fail.

The Insurance & Superannuation Commission ["ISC"][23] supervises the life insurance and superannuation[24] industries, providing policy advice and consumer protection, but such supervision sets arbitrary guidelines, contains only some risks and is little more than ad hoc tinkering. Only registered companies can carry on life insurance business[25]. The prime purpose of these constraints is prudential, to protect policy holders by requiring minimal capitalization ($2m), financial & statistical returns, disclosure statements and regular auditing.

3. REASONS AGAINST OFFICIAL SUPERVISION OF FINANCIAL INSTITUTIONS

(a) Moral Hazard

Arguably, the very presence of a LOLR (being an implicit guarantee), let alone express government guarantees of DTFIs or insurance for depositors[26], actually fosters moral hazard: that is, it encourages a gambling mindset in DTFI management, which then takes nonprudential risks upon the surmise that someone else will constrain them if they go too far, or that in the end no-one can be really hurt since exposure is insulated[27].

(b) Market Distortions

Regulations are likely to introduce inefficient distortions as market operators seek to avoid their effects: examples abound. [28] Central banks are no more than inefficient & unprofitable

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19 Ibid. Part 7.3.

20 Ibid Parts 7.4-7.8.

21 Ibid. Part 11.

22 SS. 124-128.

23 Established under the *Insurance and Superannuation Commissioner Act*, 1987.

24 Superannuation, especially, is becoming a huge industry and source of lending as government (fearing the inability of the workforce to support a large "greying" population) legislates for compulsory contribution by workers and employers, portability and constraint upon maturity.

25 *Life Insurance Act*, 1945.

26 Systems which exist in e.g. Canada and the USA, with marked lack of success.

27 There is a view (especially in the USA) that some institutions are "too large to fail": the market solution, of just allowing liquidation, is avoided. Hence the S&L were propped up, and the Scandinavian government stepped in, at great cost, to save their banks. Probably the RBA would not allow one of the "Big 4" to fail.

28 For example, it used to be argued that dictating interest rates helped homeowners & small businesses,

nationalized industries whose attempts to destabilize forex markets and manipulate exchange rates give money away to smart private speculators.

(c) Incompatibility with Implementing Monetary Policy

Reserve banks are often chartered to implement government macroeconomic & monetary policy aimed at manipulating the money-supply so as to minimize inflation, keep prices stable, dissuade inefficient & distorting behaviour, promote full employment and guard against (alleged) free-market failures. The RBA is chartered[29] with the broad macroeconomic objectives of maintaining in Australia stable currency, full employment and economic prosperity & welfare. Not only are these goals sometimes divergent inter se, but monetary policy itself can be starkly inconsistent with the RBA's prudential and LOLR roles, which must be exercised flexibly and disregarding monetary implications[30].

If fact, monetarism has zero credibility in successfully performing any of its purported functions, and is completely without utility[31]. It is in fact Land Monopoly which creates & enables inflation

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prevented cut-throat competition which might encourage risky investment by banks, and avoided sharp fluctuations. However, in fact low income earners were inconvenienced by constraints upon the earning-power of their savings, as much as they were by higher interest on their borrowings.

Similarly, capping home loans distorted the availability from banks of funds for that purpose, enabling uncontrolled NBFIs, private lenders, solicitors with trust funds etc. to frustrate policy, and borrowers from banks to on-lend at higher rates. Thus, capping interest rates distorted investor deposit with banks, impacted unequally on various customers, blunted the competitiveness of controlled institutions, encouraged direct financing at the expense of intermediation and caused market fragmentation. Nor does capping interest rates necessarily inhibit imprudent lending since banks are constrained in lending by what deposits they can attract: a prudential balance between interest paid to attract deposits and interest received on loans thereof is bound to eventuate in a competitive economy.

Maturity restrictions on interest-bearing bank deposits (whereby banks were forbidden acceptance of deposits for terms exceeding four years or less than 30 days) were intended to give government a monopoly in long-term paper, and to constrain volatility in deposit holdings. However, there restrictions provided no benefit and only reduced the efficiency of the market (See Campbell Report, 4.27 - 4.29). Similarly, quantitative lending controls fostered avoidance by uncontrolled intermediaries and impacted unfairly on small borrowers (who were dependent on banks).

Another example would be the Statutory Reserve Deposit ("SRD") whereby banks were required to lodge a fixed proportion of their deposits with the Reserve Bank, ostensibly to guarantee liquidity. In fact, SRD just locked up bank assets at low interest and thus acted as a tax & stick to beat commercial banks into complying with government policy.

Prohibition on branch banking (as in the USA) fragments banks into many brittle units. Literally thousands of these failed in the 1930's: none did in Canada, where branch banking was allowed. Arguably, this inappropriate regulatory restriction was instrumental in fostering panics. Anti-branching rules, reserve ratios and constrictions on note-issue can work against prudent liquidity by preventing effective mobilization of reserves to meet calls, instead promoting an interbank scramble for base money.

Other unwarranted regulations include divorce of commercial from investment banks, and state-sponsored deposit insurance (which, besides being actuarially unsound, tends to encourage risk-taking by both managers, who pay the same premium anyway, and depositors, for whom the potent weapon of a bank run is superfluous.

[29] See s.10 of the *Reserve Bank Act* (1959).

[30] Thus, for instance, in the recovery phase of 1992-3 the RBA failed to reduce interest rates in accordance with wise monetary policy because, in accordance with prudential policy, it wished to assist banks to rebuild their assets.

[31] Monetarism actually <u>promotes</u> inflation, since a secret (even unspoken) coalition of government & bank

and promotes rich-poor gap (by allowing speculative investors in sites to reap unearned profits) and raises interest & unemployment rates (by distracting investment from productive enterprise). Monetarism is just futile tinkering with effects so long as Land Monopoly causes inherent economic turgidity.

(d) Regulatory Capture

Regulators are prone to "capture" by the industry that are supposed to control. For regulation to work, it must be accepted in the industry: this fosters compromise by bureaucrats and tight licensing (connived at by both sides) so as to maximize players' profits. Political lobbyists parasitize on the whole scene, using the political process to transfer wealth from the public to special interest groups. Thus there are current accusations that the ASC has been captured by the Financial Planners Association, and that the ISC has been captured by the big Life funds (such as AMP & NML), which (in breach of trust law and the legislation) quite flagrantly utilize "tame"

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officials against the public is inevitable as both have a vested political interest in stimulating short-term employment and tax-take. This interest inevitably promotes inflation (which should be nil for social optimality).

Monetarism fosters price volatility (with extensive consequent inefficiencies for planning & accounting) because artificially injecting & removing liquidity from the economy unbalances natural stabilization. It creates "noise" and confuses householders' observation on pricing & firms' production planning: both are fooled into doing what they would not normally have done.

Monetarism encourages inefficient & distorting behaviour, since the public doubts its prognostications and is forced to distort & hedge.

Monetarism causes unemployment by constraining money supply at times the free market needs it. Certainly the stagflation of the '70s revealed that Keynesianism "pump-priming" was barren -- even massive & continuous injection of money into the economy had not resulted in long-term, stable employment: rather it fostered inflation in prices, wages & costs. This realization led to the monetarist gospel, the "Friedman rule", whereby macroeconomic monetary policy constrains the aggregate money-supply to growth at a predetermined rate. However, this rule & rate is artificial, inflexible, removed from the "instant pulse of the markets" and doomed to irrelevance & distortion quite as bad as unrestrained Keynesian inflation. It is trading banks who are "at the coalface" and in a much better position to gauge (and by private note-issue to satisfy) public demand for money supply.

Printing money is an easy way to raise revenue (although excessive abuse will destroy the economy) and can corrupt government motivation. By increasing the volume of money in circulation, monetarism fosters inflation which pushes people into higher tax brackets ["fiscal drag"] and reduces the real value of government debt. Sometimes governments pressure banks to make it loans: this happened in Britain 1793-7 and during the American Civil War. In both instances, bank reserves were so depleted that convertibility had to be suspended. The RBA's control over interest rates is often used (albeit with dubious utility) for purposes beyond the constitutional powers of the Federal Government, such as manipulation of market behaviour, importing and employment.

Furthermore, macroeconomic disturbances are exacerbated domestically by the fusion of two media, those of account & exchange (both of which is the dollar). This means that actual quantity of money available can fail to correspond to the total of money holdings desired at the existing price level. At a domestic level, money does not have an adjustable price of its own, so that imbalances of supply & demand impact on general prices. In this vein, it is interesting to observe that convertibility of currency for gold at a fixed price would avoid the LOLR/monetarist conflict and make prices predictable.

It can be argued in reply that reserve bank implementation of the Friedman Rule has enabled low, if steady, inflation without wholesale institutional reform, and that we should be grateful for small mercies. This may be so, to the extent it goes, but the "Friedmanite Coalition" may only be a temporarily expedient, it fails to give weight to unemployment or to recognize the huge political & bureaucratic costs involved, and it abandons the ideal of zero inflation.

trustees and fail to get independent audits whilst "little players" who complain are punished by oppressive investigation.

(e) Cost

The volume & complexity of work required in official supervision of FIs is vast & expensive, especially given the skills & equipment required. Further, there is a tendency for regulators (knowing that they are likely to be assessed on their failures) to introduce costly "overkill" mechanisms. This tendency has been resisted as regards supervision of banks (where "persuasion" is preferred to "prescription" and no on-site inspection occurs), but is arguably evident in, e.g., the complexity & heaviness with which prospectus requirements are imposed.

(f) Paternalism

The existence of any supervision at all can be criticized as "pervasive, institutional, autocratic, costly and inconsistent with a general thrust towards a deregulated and more efficient financial system"[32]. There are only three valid reasons for regulating an industry: breaking up natural monopolies (which arise with decreasing average costs), controlling negative externalities (e.g. pollution or contagion) and asymmetric information (which can make it very hard for consumers to define the best deal).

A natural monopoly arises when marginal costs decrease as output rises, and this tends to produce "too little" output. There are none in the deregulated financial sector since competition soon erodes the rising output.

The tendency of an industry which is allowed to produce unrestrained externalities is to produce "too much" output, since it avoids the social & environmental costs of its activity. The major alleged externality of the DTFI industry is the risk of contagion if collapse of one DTFI spawns bank-runs on others, however this allegation is spurious[33]

Asymmetric information spawns its own tyranny, but can be countered by prospecti, compulsory disclosure statements (e.g. of set-up costs, interest rates, commissions & fees) and by dealer answerability. Government regulation over this aspect of the intermediation industry cannot be dismissed as paternalistic.

(g) Empire-Building

LOLR and regulators are, in the last analysis, bureaucrats who want to preserve their privileges and avoid scrutiny: they have a volition of their own and are quite happy to mount rescues so as to minimize "waves", despite the cost to taxpayers and the moral hazard with which such implicit guarantees entice bankers. Any politicization & regulation of the money supply involves (self-serving) bureacratization, imposition of a few "ivory tower" opinions upon a hugely complex & changeable market situation they can never comprehend (especially given lags in information) and which it is impossible to collect & process centrally, subversion by lobbies, distortion & disharmony of freewill inspiration. Establishment prejudice against airing the Land Monopoly and Fiat Currency debates does not help clear or settle the turgid economic waters. Immune to market pressures, bureaucrats rapidly eschew public spirit or devotion to duty, absorb effort without responsibility and become positively hostile & obstructionist.

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[32] Hogan & Sharpe "On Prudential Controls", Economic Papers April 1983.

[33] See below 3(h) and 4(b) below.

(h) Inutility

Deregulated FIs have failed throughout the world despite supervision, perhaps substantially due to the distortion engendered by monetarist interference and the moral hazard engendered and the segregation of ownership from management[34]. The banking industry is quite free capable of protecting its own liquidity if left free to do so: monopolization of note issue suppresses such free market automatic stablization mechanisms as the issue of private notes and inter-bank clearing-houses for same, thus enabling the artificial argument that LOLR is necessary to protect against bank runs. Competition forces efficiency: the ability of a trading bank to manoeuvre is heavily constrained by its rivals and by constant & immediate feedback from market exposure.

Bank runs are not random events like sunspots. They are related to public perception of the bank's balance sheet is continuously monitored & reflected in the equity (stock) market and the secondary market for the bank's bills[35]. Banks can guard against insolvency by prudent loans, portfolio diversity, hedging, etc., and against illiquidity. Runs are the effect, not the cause, of adverse public perception.

PART B. WHAT ARE THE ADVANTAGES AND DISADVANTAGES OF REPLACING THE CURRENT COMMONWEALTH SUPERVISORY SYSTEM WITH A SINGLE REGULATOR?

4. ADVANTAGES AND DISADVANTAGES OF A SINGLE REGULATOR

(a) Overview

In a context of appropriate reform, there is little need for any regulator at all. Such reform would terminate artificial monopolies over currency-issue and land, and would underscore the need for owner & manager responsibility in the FI sector. The only official supervision which would remain necessary concerns provision of informational symmetry in the free markets, and there is no advantage in that role being divided between several regulators.

(b) Private Currency

Money is only a medium of exchange and any token accepted by contracting parties will suffice. Acceptance, however, is geared to trust & convertibility: if the token is known, with certainty, to be convertible to an intrinsically-valuable commodity (e.g. gold ["specie"]) then it will be acceptable, and inconvertible fiat currency, which exists only by force of law, will be ignored. The conversion rate should be set at the time of issue so that risk in maintaining or bettering the profitability of that rate rests with the issuer. It would be possible for private specie-conversion entitlements to be logged centrally for electronic transactions.

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[34] "Legal restrictions on banks have arguably hindered the development of run-inhibiting arrangements such as branch banking, contractual suspension clauses and mutual-fund-based payment accounts. " G.A. Selgin and L. White "How Would the Invisible Hand Handle Money?" in Journal of Economic Literature December 1994, page 1744.

[35] This secondary market is, however, becoming less important as the importance of deposits supersedes that of notes, and it is replaced by an interbank cheque-clearing system (operating at par), depriving the public of a useful indicator and exacerbating the likelihood of an irrational run.

Until the First World War, all paper currencies (whether issued by government or private FIs) were convertible to gold, so banks had a strong incentive to avoid a run. Central bank notes were at first convertible, but once they became accepted & established as legal tender, conversion tended not occur and stocks of gold lodged centrally. Thereupon, convertibility ended! Nowhere, historically, did convertibility end as a spontaneous market phenomenon.

The ostensible reasons behind proscribing "private paper" as legal tender (i.e. as payment which citizens have to accept and the government will accept) is that mandating such would lead to an endless flood of printing notes which would rapidly become worthless. This is clearly wrong where the notes are convertible. The only convertible notes which could remain in circulation are those for which there is demand (due to advantages in portability, security, exchange etc.). All others would be converted. Issuers would simply be unable to keep in circulation notes for which there was no demand.

Note-issuers could be expected to branch widely, reducing redemption costs, and reputable banks could be expected to redeem each other's currencies at par. Issuers would be forced to behave prudentially in issuing convertible notes since reserves & deposits held would have to suffice as an anchor enabling, at any given moment, redemption. Legal tender would (by dint of common law contract) be whatever parties agreed to accept in exchange, but in default legislation could list a bundle of types, all of which would be available to pay government.

Counterfeiting is really a problem only when there is a large volume of the relevant note in circulation for a long time: this makes detection difficult. Quite the converse would be true with private convertible notes, which would tend to be circulated, or deposited to the holder's EFTPOS credit, quickly. Counterfeiters can be traced more readily, and banks could afford to honor bona fide presentations.

The banking industry is quite free capable of protecting its own liquidity if left free to do so: monopolization of note issue suppresses such free market automatic stablization mechanisms as the issue of private notes and inter-bank clearing-houses for same, thus enabling the artificial argument that LOLR is necessary to protect against bank runs.

Yet the very presence of a LOLR (by being an implicit guarantee) actually fosters moral hazard. The reaction is central regulation (whether by suasion or compulsion) of bank activity: this is an inherently massive & arbitrary task which inhibits portfolio diversification, imposes compliance costs, distorts activity, fosters off-balance-sheet evasion.

In order to avoid all this barren activity, LOLR and note monopoly must be eliminated. Banks would naturally exercise restraint in note issue (usually via loans to borrowers) lest presentation for redemption (especially by discerning & disciplined clearing-houses) erode reserves. They would be constrained in note-issuing by public demand to <u>hold</u> their notes. Free Banking experience[36] evidences no trend towards over-issue. Yet LOLR, holding a monopoly on note issue, lacking pressure to make its fiat currency convertible[37], and with no domestic note-clearing house to check it, faces no such constraint.

Free banks could deal with a deposit run (where notes are accepted) simply by creating more notes.

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36 E.G. in Scotland, Canada, Sweden and antebellum USA: See Kevin Dowd *The State and the Monetary System* St Martin's Press New York (1989) p.47..

37 No major currency has been convertible since the collapse of the Bretton Woods system in the early 1930's

A note run (where conversion to specie is demanded) is more difficult since obtaining stocks of specie takes time, especially where other assets must be liquidated to purchase it. This impasse can be avoided by placing an "options clause" in the note contract permitting deferral of redemption for a period provided interest is paid. This clause would allow banks to liquidate assets and obtain specie, and would have the added advantages of dampening off runs (since depositors would know they could not get their specie immediately, and that there was no advantage in being "head of the queue").

Failure of a FBS bank to redeem its notes in base currency might arguably trigger contagious nationwide runs, but crises of confidence have been rare historically (especially in countries lacking central banks as lenders of last resort[38], even during the "great contraction" of 1930-33, and largely sprang from legal regulation itself.[39].

(c) Ending Land Monopoly

Private control over sites is essential for privacy & security, and hence for investment & productivity. Sites (which were not made by humanity and are a distinctive factor in production) are thus in demand and command a price which reflects their value, whether due to location or to natural endowment. It is impossible for an economy to balance (and perpetuation of the boom-bust cycle will continue) unless the financial advantage bestowed upon siteholders is collected as public revenue. This can be done by "Site Revenue"[40]: i.e. collecting the rental-value (on an "unimproved" basis) of sites privately occupied, whilst not disturbing ownership of them and their improvements. Indeed, there is no other logical source of public revenue, since all taxes upon effort or transactions serves to suppress or distort them.

If the site revenue is not collected, value inheres to the site above the value of improvements to it. Then, when the site is used as security for a loan, the reliability of that security is eroded when bust conditions replace boom. Failure to stabilize site-values by not collecting site revenue, and the basing of securities upon false premises, occasioned many major corporate collapses after the excesses of the late 1980's.

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38 Selgin, G. "Are Banking Crises a Free Market Phenomenon?", Uni. of Georgia m.s. (1994)

39 "Serious regional contagions erupted in late 1932, but these were aggravated if not triggered by state governments' policy of declaring "holidays" in response to mounting bank failures." Selgin "How Would the Invisible Hand Handle Money?" by Selgin, G.A. and White, L. in Journal of Economic Literature December 1994, p.1726.

40 The Site Revenue proposal (sometimes called the "Single Tax") was first propounded in detail by Henry George in *Progress and Poverty* (1879); *Social Problems* (1884); *The Condition of Labour* and *Protection or Free Trade* (1886) and *A Perplexed Philosopher* (1892).

George's basic analysis has remained intact intellectually for the last century and has been endorsed, from time to time, by various major thinkers: "It is quite true that land monopoly is not the only monopoly that exists, but it is by far the greatest of monopolies -- it is a perpetual monopoly, and it is the mother of all other forms of monopoly." (Winston S. Churchill *The Peoples' Rights* Jonathon Cape Ed., London, 1970 at p.117). "The unearned increment in land is reaped by the land monopolist in exact proportion, no, not to the service done but to the disservice done." (Speech by Churchill at Edinburgh, 17 July 1909 as reported in his Liberalism and the Social Problem. "The earth, being the birthright of all mankind, its rental is the property of the people. Thus the site rent is the debt owed to the community by every landed proprietor, the duty of the State being to collect that debt as its revenue, to utilize it for the purposes of the community and not to tax." Tom Paine, *Commonsense.*

For a modern analysis, see Fred Harrison *The Power in the Land* Shepheard-Walwyn, London (1983) and Steven B. Cord *Henry George: Dreamer or Realist*? Uni. of Pennsylvania Press, 1965.

So long as individuals can pocket community-created increases in site value, investment will be distracted away from productive enterprise, unemployment will exist, the currency will be inflated (since such profits do not reflect true extra goods & services in circulation) and interest rates will be high (or even exist at all).

(d) Single or Multi Regulators?

Such official supervision of DTFIs as persists after deregulation is superfluous or counter-productive and should be allowed to evaporate in a free market climate, especially one where institutions can issue their own convertible notes in an atmosphere relieved of Land Monopoly and hence any excuse for Monetarist interference. In such circumstances, there would be no need for any specific regulator in the DTFI sector.

If, however, state monopoly over legal tender (and an inconvertible fiat currency at that), Land Monopoly, Monetarism, corporate irresponsibility and official supervision of FIs are to remain as major distorting influences, then there is no real point in distinguishing between deposits with banks and those with NBFIs. The same parameters of concern (assets, liquidity, exposure, auditing etc.) apply in each instance and the regulatory functions of AFIC might as well be fused with those of RBA, provided jurisdictional problems can be overcome. The NBDTFIs really only owed their growth to the market distortions wrought by regulation, and they have clearly declined (or converted to banks) since deregulation. AFIC is in danger of having very little left to supervise. In any event, the RBA serves no utility in supervising banks (such as the Commonwealth Bank) which are guaranteed by government.

Similarly, market forces applying to long term savers, such as Life & Superannuation Offices, can safely be relied upon to stimulate prudential behaviour without the need for a specific regulator. Both these types of FI are exposed to operational, credit, asset & contingent risk. The Life and Insurance sector is exposed to conglomerate risk and has a particularly high exposure to operational risk since major unforeseen events, e.g. earthquakes or bushfire, can lead to extensive claims. Whilst no regulatory (as opposed to market) supervision exists over the investment policy & performance of either, none can be effective or necessary over their formal operations either so long as annual reports and audits are required by the Corporations Law and are subjected to market scrutiny.

There is no disadvantage in having a single regulator whose role is restricted to the only one which is validly appropriate: avoiding informational asymmetry between the public and FIs throughout the industry. Whilst the financial industry is vast and naturally segmented (into e.g. DTFIs, the securities markets, stock & futures exchanges, money markets, insurance, superannuation etc.), all these areas are corporatized and, so long as informational symmetry is maximized by compulsory prospecti, annual returns, market reports etc., the market itself will be able to judge & reflect reliability in share prices or exchange rates relating to corporate bills & bonds.

Apart from this supervision of informational symmetry, there is no role at all in the FI sector for supervisory bodies, whether general or specific in their focus.

PART C.
CONCLUSION

#7. CONCLUSION

The valuable role of FIs can be protected by one form of regulation alone: that over informational symmetry. All other forms of supervision are based upon false reasons and are unmerited and/or counter-productive, especially in an environment where the major distortion caused by the monopolies over fiat currency and land are ended. Preferably, consideration should also be given to heightening owner & manager responsibility in the FI sector by altering equity & remuneration exposure.

There is no justification for giving responsibility over supervising informational symmetry to other than a single official regulator.

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