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Liberty Works
Liberty Powers Progress

<u>*Banking Bad*</u>

The buck stops with BIG GOVERNMENT

"What is needed…is to place…banking…under the general rules of commercial and civil laws compelling every individual and firm to fulfill all obligations in full compliance with the [normal] terms of [a] contract."

– Ludwig von Mises

Contents

Introduction

- **Thank you** for the **opportunity** today to testify before the Committee.
- I am **Darren Brady Nelson**, and I am here today representing **LibertyWorks** as the Chief Economist and a member of the Advisory Board.
- I am also currently the economic policy adviser to **Senator Malcolm Roberts**, and have been for the past 12 months. I am not here today in that capacity.
- I was previously an economic policy adviser in the presidential campaign of **Donald J Trump**.
- Many 'moons' back, I graduated in **economics with honours** from ANU in the mid 1990s and in law with distinction from UNSW in the early 2000s.
- I have been a **professional economist** since in the mid 1990s, in the private, public and non-profit sectors.
- Since 2008, I have taught myself the more realistic, reliable and relatable **Austrian School of economics**.
- **My testimony today** before the Committee will go through the economic logic and evidence, both mainstream and Austrian, supporting the provocative title of:

Banking Bad:

The buck stops with Big Government

Issues I: Drivers

- It is the **macro level issues** in money and banking that ultimately drives and sustains most if not all of the micro level problems in lending to primary production customers.
- The key macro level issues arise as a **result** of **government failure** not of market failure – ie government control over market freedom.
- These, in turn, primarily emanate from a plethora of **government legislation/regulation** especially that to establish and/or maintain an exclusive:
  - A) **central bank 'monopoly'** on unsound currency-based money by the Reserve Bank of Australia (RBA);
  - B) 'license' to create credit-based money not properly backed by sound money and deposit assets (or 'out of thin air', as renowned economist Murray Rothbard has put it) through '**fractional reserve banking**'; and
  - C) 'cartelisation' of the Australian banking industry by the **Big-5 Banks** – ie ANZ, Commonwealth, National Australia, Westpac and Macquarie.

Issues II: Impacts

- The three macro level issues (above of #A, #B and #C) drive the **micro level problems** (below of #i, #ii and #iii) in primary production lending by:
  - i) making available to banks **‘easy’ money and credit** (through #A and #B) and thus strongly dis-incentivising banks to behave efficiently and ethically … because money and credit are not ‘scarce’ for banks nor do they have sufficient ‘skin-in-the-game’;
  - ii) dis-incentivising banks further to behave efficiently and ethically (through #C) by granting **anti-competitive favours** to the Big-5 unlike for the rest and imposing anti-competitive barriers on the rest unlike for the Big-5; and
  - iii) facilitating #i and #ii as well as **unfair contracts** and other anti-social behaviour through the plethora of government legislation/regulation which in particular ‘crowds out’ the common law of property, contracts and tort.
- The **common law** once formed the historical basis for the rule-of-law. On the other hand, government legislation/regulation now forms the current basis for being ruled-by-laws.

Issues III: Players

- **The key players** in this system are:
  - the **Big-5 Banks** (through #B and #C as well as #i, #ii and #iii);
  - the **RBA** (through #A as well as #i and #ii); and
  - especially the institution of **Big Government**, which makes all of the above possible.
- This **system grants** uneconomic and unethical '**power**' to not just the RBA (to print unsound money) but to the Big-5 Banks as well (to lend yet more unsound money). And therefore, as the old saying goes, "power corrupts".
- In a 'nut shell', an anti-competitive and anti-consumer **'pyramid' or 'Ponzi' scheme** has been established and maintained by Big Government legislation/regulation.

Analysis I: Failure

- These macro level issues arise, and the resulting micro level problems, are due to **government failure** not market failure – ie government control over market freedom.
- Government failure is very common and arises for a number of reasons. Professors Susan Dudley and Jerry Brito of the Mercatus Center provided some of the reasons from a mainstream **Public Choice Theory** perspective in a book entitled *Regulation*:
  - "[M]arket interventions may produce government failures. That is, even when a market failure is observed, a particular government intervention may produce even more inefficiency than the *status quo* as a result of the **rent-seeking** problem, **unintended consequences**, or both."
- Eminent economist **Ludwig von Mises** wrote many decades before in his book *Socialism* that:
  - "[Government interventionism] suffers not only from a problem of incentives, but also from a problem of knowledge … [ie] government planners cannot engage in **economic calculation**."
- Professor Mises added in his later book of *Bureaucracy* that:
  - "The failure … was certainly not due to incapacities of the personnel. It was an outcome of the unavoidable weakness of any **administration of public affairs**."

Analysis II: Cycles

- Many of the greatest economists of 'all time' have recognised the massive economic dangers from large **increases** in the **money supply**, sometimes known as simply printing money … usually accompanied by the legalised fraud known as fractional reserve banking or fractional reserve lending.
- These dangers include causing, or at least making far worse, both economic booms and the resulting busts (mistakenly) called the **business cycle**, as well as the rising cost-of-living also (mistakenly) called inflation.
- The **boom-bust cycle** is mistakenly called "business" as it is primarily caused by government interventions in money and banking, and is not a natural and unavoidable feature of free market capitalism. This was recognised in the award of the **Nobel Prize in Economics** to Friedrich von Hayek.
- The **cost-of-living** is not inflation but is caused by inflation of money and government.
- **Cycles and inflation** are actually 'flip-sides of the same coin' of artificially rising values and prices effected by the cause of artificially rising quantities of moneys or money inflation. The boom-bust cycle typically happens first, with its uneven and less general price rises, followed by price inflation. The latter is a general price rise and thus a loss of the purchasing power of money for all, especially the poor and middle class.
- Both of these phenomenon redistribute and destroy real wealth and jobs, and thus create distinct **winners and losers**.

Analysis III: Inflation

- Noted economist Dr Bob Murphy wrote regarding inflation in *Lessons for the Young Economist*, that although a rising stock of money and a general rise in prices typically go hand-in-hand, there is **not** a precise **one-to-one** connection between money and prices:
  - "For example, if the amount of money goes up by 10% in one year, one can't automatically assume that amount."
- Australian-Israeli economist Frank Shostak highlighted regarding **inflation and economic growth** that:
  - "Most economists believe that a growing economy requires a growing money stock, on grounds that growth gives rise to a greater demand for money which must be accommodated. … When we talk about demand for money, what we really mean is the demand for money's purchasing power. … [I]n the free market, people will not accept a commodity as money if its purchasing power is subject to a persistent decline. [I]n the present environment, central authorities are coercively imposing money that suffers from a steady decline in its purchasing power. … In short, within the framework of a free market, there cannot be such thing as 'too little' or 'too much' money."
- Regarding the **winners and losers** from inflation, Lord John Maynard Keynes once said:
  - "By a continuing process of inflation, governments can confiscate, secretly and unobserved, an important part of the wealth of their citizens. By this method they not only confiscate, but they confiscate arbitrarily; and, while the process impoverishes many, it actually enriches some."

Analysis IV: Decay

- Prominent economist Dr Gary North argued in his book *Honest Money* regarding inflation that, in the face of easy and rising money and credit, businesses (or labour) face **three main choices** in trying to remain competitive:
  - **firstly**, selling the same good/service (or labour) at the same price (or wage) and getting stuck with the now inflating and devaluing currency;
  - **secondly**, selling the same good/service (or labour) at a higher price (or wage) and risk losing sales, revenues and profit (or jobs); or
  - **thirdly**, selling a lower quality of good/service (or labour) at the same price (or wage).
- Economic **incentives** are strongest for the **third choice** (especially in the shorter term) or for some combination of choices two and three (especially in the longer term).
- Note that **ethics** comes into play most strongly for **choice three** – ie low-quality-fraud (by businesses and labour) prompted by money-supply-fraud (by Big Government, central banks and Big Banks).

Support I: Politicians

- Former Treasurer **Peter Costello** said in July 2017 (from The Australian):
  - "Sometimes I wonder whether those running the banks realise how important the government is to their business. Who benefits from this tightly regulated enterprise? Well, the government does, the shareholders of course, and the senior executives employed on handsome salaries to keep their operation ticking over. It's the consumer that is feeling unloved."
- Senator Malcolm Roberts and Treasury Secretary **John Fraser** said in May 2017 (from Senate Budget Estimates Hansard):
  - Roberts: "Isn't it the case that such money supply inflation has been the key driver, at least on the demand side of the economy, of the rising Consumer Price Index in recent decades?"
  - Fraser: "It is a hard one; I do not have an answer. I am a traditionalist, so I see money base growing like this, and it worries me but, every time I carry on and talk about the inflationary impact, everybody laughs and says, 'You're showing your age'—which I am. That is a non-answer, but it is interesting and I know that a lot of the people in treasuries around the world look at it and say the same thing: 'We do not have an answer'."
- Former Prime Minister **John Howard** and a concerned citizen said in March 1991 (from signed correspondence):
  - Citizen: "Does the Coalition support the system where the banks can create money (credit) out of thin air?"
  - Howard: "yes"
  - Citizen: "Will the Coalition pass the laws to forbid this system which is very clearly a fraudulent one?"
  - Howard: "no (and it is not 'fraudulent')"
  - Citizen: "Does the Coalition recognise that the primary cause of the current recession was the huge credit creation binge that followed deregulation? This increased the money supply so massively it created a false boom."
  - Howard: "yes (but the binge, not deregulation, was the cause)"
  - Citizen: "Does the Coalition recognise that increases in the money supply causes inflation (and a false boom) and that inflation erodes the value of peoples savings and encourages people to spend instead of save, and that inflation is stealing the wealth of all Australians?"
  - Howard: "yes"

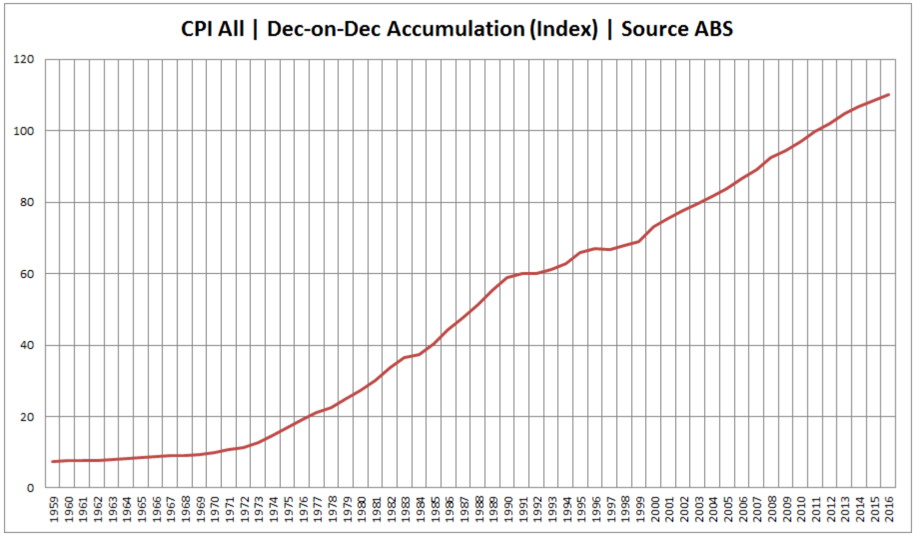
Support II: Economists

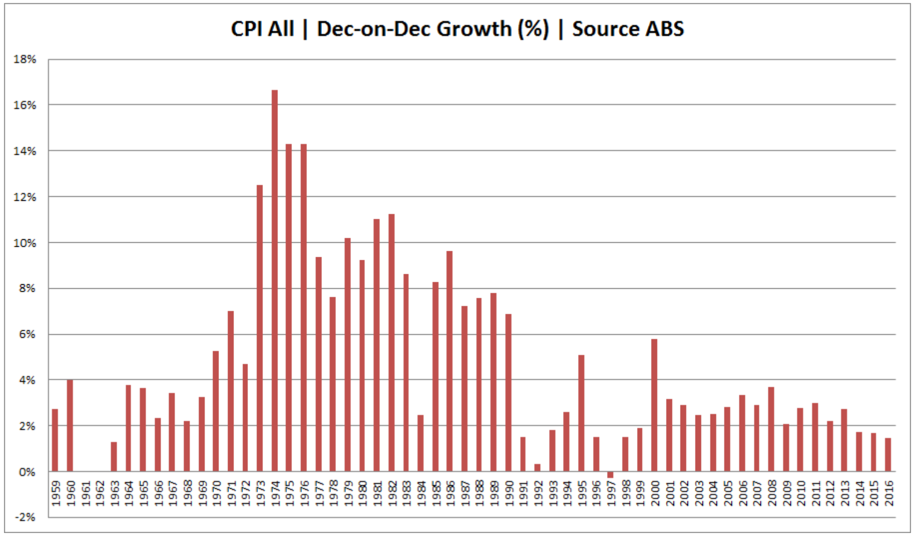
- Our submission listed **twenty reading sources** on money and banking.
- Our **suggested best three** of these were:
  - Friedman, *Money Mischief*;
  - Leithner, *The Evil Princes of Martin Place*; and
  - Rothbard, *The Mystery of Banking*.
- **Murray Rothbard**'s book will be discussed a little later.
- In the book by Nobel laureate economist **Milton Friedman**, he wrote:
  - "Inflation is always and everywhere a monetary phenomenon in the sense that it is and can be produced only by a more rapid increase in the quantity of money than in output."
- Australian financier **Chris Leithner** concludes in his book that:
  - The RBA "doesn't fight inflation, it manufactures and maintains it".

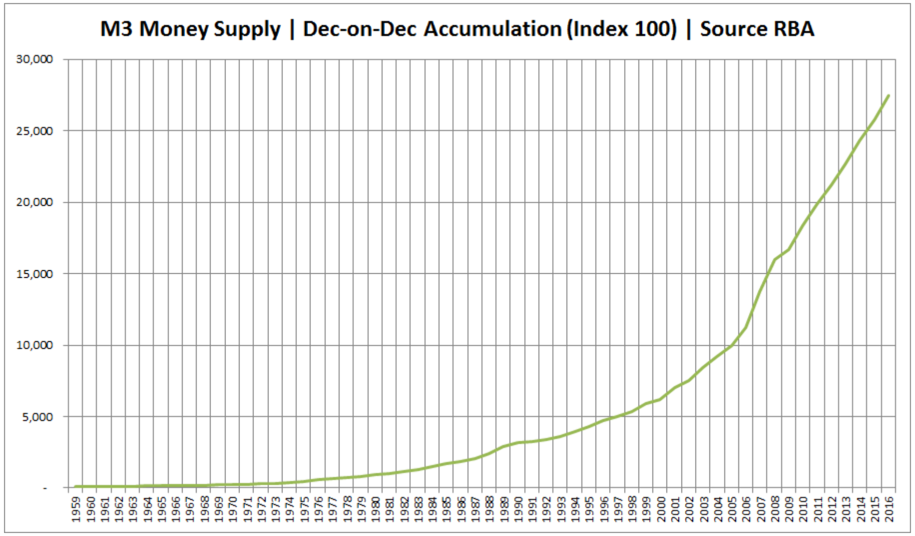
Support III: Statistics

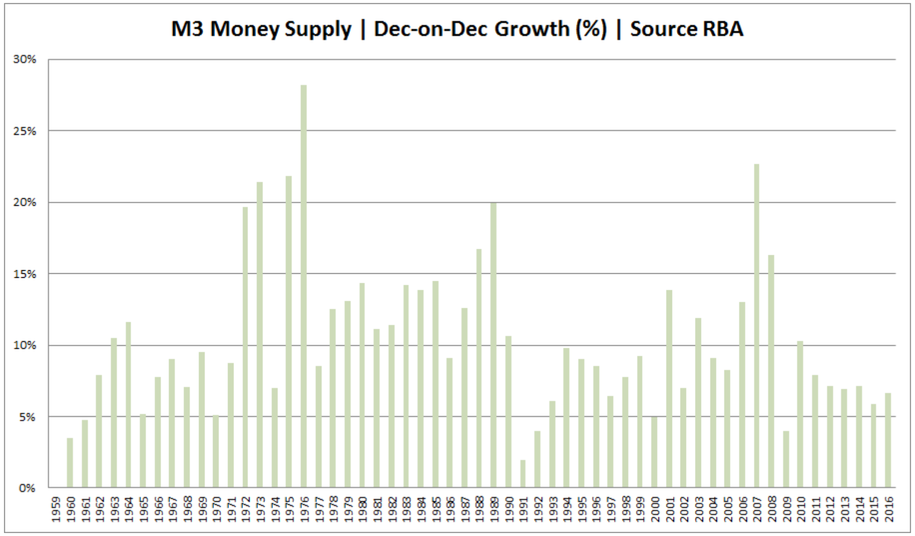
- **Price inflation**, as measured by the consumer price index (CPI), appears to highly **correlate** with money inflation, as measured by M3 (money supply).
- However, **CPI** regularly understates price inflation each year by approximately half compared to **M3** due to: flaws with the CPI measure; and money inflation in the short-to-medium term not equating (one-to-one) to price inflation.
- Even though price inflation doesn't look as bad as money inflation, it is still not a pretty sight. **CPI and M3 accumulate** like a perverse form of compound interest over years and even decades.
- Money inflation not only **causes price inflation** but it strongly facilitates government inflation.
- **Money inflation** largely works on price inflation through the demand-side for goods and services by increasing demand.
- **Government inflation** (especially taxation and regulation) largely makes price inflation worse through the supply-side for goods and services by decreasing supply.

Support III: Statistics









Support IV: Accounting

- Professor **Murray Rothbard** made extensive use of T-accounts in his book *The Mystery of Banking* to best illustrate loan banking, deposit banking, fractional reserve banking, free banking, central banking, money supply, market banking, government banking and reformed banking. As he wrote in this book:
  - "A must in making any sense whatever out of the banking system is to become familiar with the common accounting device of the **T-account**, or balance sheet [using] the Asset = Liability + Equity equation."
- The hypothetical Jones Bank (in **Figure 7.6** on the next slide) has demand liabilities, instantly payable on presentation of the note or deposit, totalling $1.8 million, whereas cash in the vault ready to meet these obligations is only $300,000. The Jones Bank is engaging in fractional reserve banking, with the fraction being $300,000 / $1,800,000 or 1/6. Or, looking at it another way, we can say that the invested stockholder equity of $200,000 is invested in loans, while the other $1.5 million of assets have been loaned out by the creation of fraudulent warehouse receipts for money.
- Suppose, for example, that stockholders invest another $500,000 in the Jones Bank, and that this cash is then loaned to various borrowers. The balance sheet of the Jones Bank would now appear as shown (in **Figure 7.7** on the next slide). Thus, while the Jones Bank has extended its credit, and its new extension of $500,000 of assets and liabilities is legitimate, productive and noninflationary, its inflationary issue of $1,500,000 continues in place, as does its fractional reserve of 1/6.
- If banks remain fully loaned up, then the amount that, in the aggregate, they will pyramid on top of reserves can be precisely known: It is the inverse of the minimum reserve requirement (MRR). Thus, if the legal reserve requirement is 1/6 (total reserves / total deposits), the banks will be able to pyramid 6:1 on top of new reserves. The amount banks can pyramid new deposits on top of reserves is called the **money multiplier** (MM), which is the inverse of the MRR. In short: MM = 1 / MRR. Since banks earn their profits by creating new money and lending it out, banks will keep fully loaned up unless highly unusual circumstances prevail. Raising MRR, then, is contractionary and deflationary; lowering them is inflationary.

Support IV: Accounting

Jones Bank

Assets		Equity & Liabilities	
IOUs from borrowers	$1,700,000	Demand Liabilities:	
		Notes	$1,000,000
Cash	$300,000	Deposits	$800,000
		Total	$1,800,000
		Equity	$200,000
Total Assets	$2,000,000	Total Liabilities	$2,000,000

FIGURE 7.6 — MIXED LOAN AND DEPOSIT BANK

Jones Bank

Assets		Equity & Liabilities	
IOUs from borrowers	$2,200,000	Demand Liabilities:	
		Notes	$1,000,000
Cash	$300,000	Deposits	$800,000
		Total	$1,800,000
		Equity	$700,000
Total Assets	$2,500,000	Total Liabilities	$2,500,000

FIGURE 7.7 — FRACTIONAL RESERVE IN A MIXED BANK

Support V: Economics

- Overall prices are determined by similar supply-and-demand forces that determine the prices of individual products. The price and purchasing power of the unit of a product are one and the same. Therefore, one can construct a diagram (in **Figure 3.3** on the next slide) for the determination of overall prices, with the price or the **purchasing power** of the **money** (PPM) unit on the Y-axis. The price or the PPM is the inverse of whatever one can construct as the price level or the level of overall prices (P). In mathematical terms: PPM = 1 / P. Hence, PPM is therefore the inverse of P.
- Below (in **Figure 3.4** on the next slide) shows what happens when the **money supply** (M) **increases**. The original M intersects with the demand for money (D) and establishes the PPM and the price level (1/P) at distance 0A. Now the supply of money increases to M'. This means that the aggregate total of cash balances in the economy has increased from M, say $100 billion, to M', $150 billion. But now people have $50 billion surplus in their cash balances, $50 billion of excess money over the amount needed in their cash balances at the previous 0A prices level. Having too much money burning a hole in their pockets, people spend the cash balances, thereby raising individual demand curves and driving up prices. But as prices rise, people find that their increased aggregate of cash balances is getting less and less excessive, since more and more cash is now needed to accommodate the higher price levels. Finally, prices rise until PPM has fallen from 0A to 0B. At these new, higher price levels, the M'—the new aggregate cash balances—is no longer excessive, and the demand for money has become equilibrated by market forces to the new supply. The money market—the intersection of the demand and supply of money—is once again cleared, and a new and higher equilibrium price level has been reached.

Support V: Economics

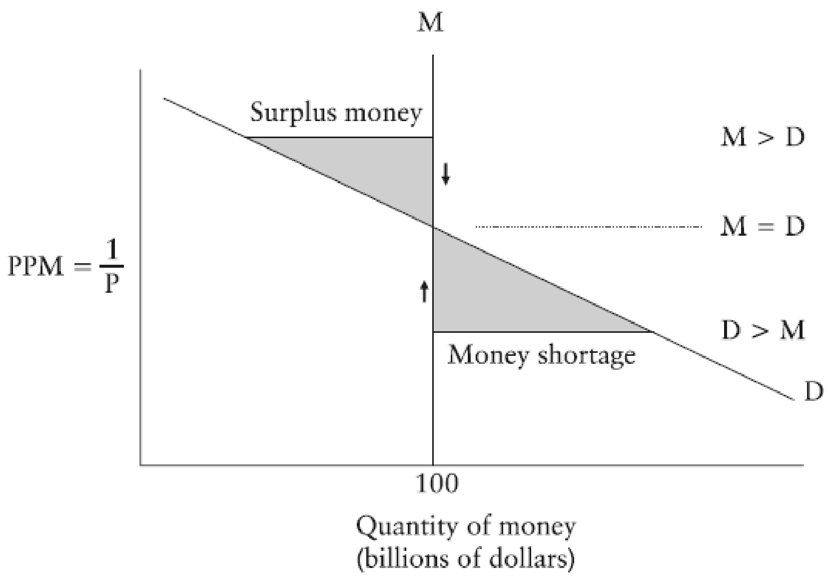


FIGURE 3.3 —DETERMINATION OF THE PURCHASING POWER OF MONEY

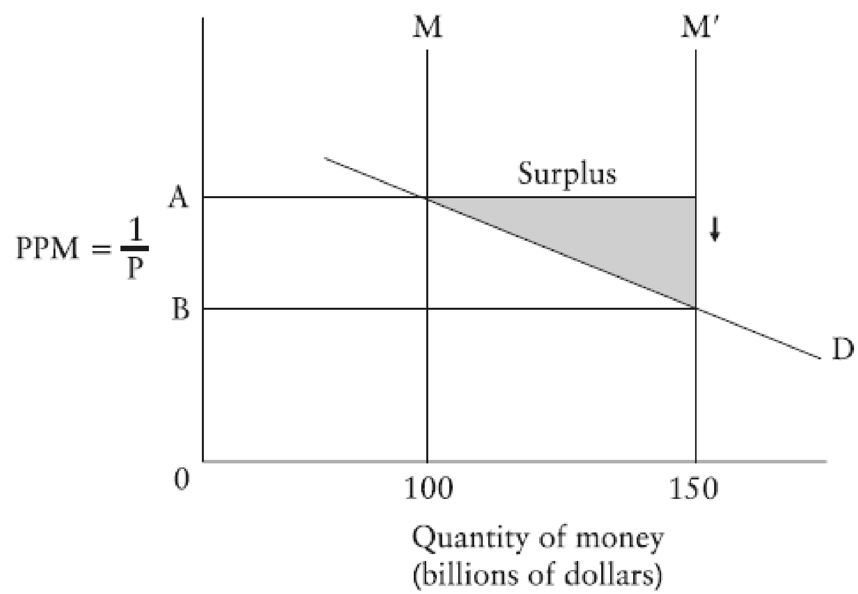


FIGURE 3.4 — INCREASE IN THE SUPPLY OF MONEY

Recommendations

- **Our suggested reforms** are therefore as follows:
  - **by October 2018**, complete a Royal Commission into the regulatory drivers of central banking, fractional reserve banking and banking cartelisation… with the aid of an Australian National Audit Office (ANAO) ‘blue team’ and an Austrian School free market ‘red team’;
  - **by October 2019**, legislate for a comprehensive reform agenda focussing on removal of regulatory barriers to sound money, free banking and banking competition … with the aid of a Productivity Commission (PC) ‘blue team’ and an Austrian School free market ‘red team’; and
  - **by October 2022**, complete the comprehensive reform agenda including National Competition Policy (NCP) style compensation and transition payments … with the aid of a National Competition Council (NCC) ‘blue team’ and an Austrian School free market ‘red team’.
- We are highly confident that our suggested reforms will not only restore **accountability, integrity and fairness** to rural banking in Australia but also be a catalyst to far greater stability, competition and innovation for the entire Australian economy for not only this generation of Australians but for many generations to come.

Conclusion

- In conclusion, **all government policies** either: A) reduce or remove market interventions; or B) add to them. “A” decreases bad banking (and the cost-of-living), whilst “B” increases it.
- Or as former **President Ronald Reagan** once stated:
  - “In this present crisis, government is not the solution to our problem, government is the problem.”
- I hope **my testimony today** … clarified suspicions about … or opened eyes to … or at least started to ‘sow some seeds’ of doubt regarding … the central role of Big Government in bad banking (and the cost-of-living).
- If this is you, then **please reflect this** in the Committee’s report and recommendations (even if only in a dissenting opinion):

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"It is extremely difficult for [even economists] to conceive of the conditions of free [market] banking because they take government interference with banking for granted and as necessary."

"There was no reason whatever to abandon the principle of free enterprise in the field of banking."

– Ludwig von Mises