Economic Saboteurs and Dullards

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Baltimore, Maryland - Melbourne, Australia
By Dan Denning
The Great Australian Bank Heist

From Dan Denning in St.Kilda:

--Here's a question you might be able to help out with as we start another week of reckoning: who made Ross Garnaut the Rasputin of Canberra? We've been in Australia for five years now and still can't figure out how an economist has managed to make himself a catch-all advisor on the mining industry and climate change. The common element to both issues: raising taxes in order to redistribute income.

--Back to rent-seeking bureaucrats and economic interventionism in a moment. What about financial markets? Well, despite the best efforts of Mother Nature and Geopolitics, stocks are holding their own. And judging by the volatility index published by the
ASX, there is not a lot of "fear" in the market at the moment.

--The trouble with the VIX is that it's a lagging indicator. It always spikes after a crisis to reflect the increased premiums on put options as hedges/insurance against more losses. Though we're not a heart surgeon, we imagine using the VIX to predict volatility is like using an EKG during a heart attack to tell a man he's having a heart attack: by the time it tells you what you need to be worried about, it's too late.

--Of course the VIX isn't designed to predict things like tsunamis or revolutions. It tells you how investors react to those events (usually defensively). But investors don't appear to be defensive at all at the moment. Not only has the VIX receded, but the Aussie dollar—the quintessential "risk" currency—is at a post-float high against the U.S. dollar. "There's low volatility, a stable VIX index and equities are doing well, so you have to be long on the highest-yielding currency you can find," ANZ's Tony Allen tells Bloomberg.

--The low volatility may change, at least for a day. Newswires report another earthquake off Japan's north-east coast this morning. It was smaller than the 9.0 quake on March 18th. But a tsunami warning was issued.

--The bigger question here is whether you can afford to be reactive to events. The market—backed by bullish fund managers and a steady tide of compulsory money—is not sending any distress signals. Mind you, it doesn't send out engraved invitations to buy when stocks are cheap either.

--Central bankers are like Terminators (cybernetic organisms). Except, instead of destroying their programmed human targets, they destroy normal prices and undermine values (investment and otherwise). This is why Sarah Connor would have made a good investment advisor with her motto, "No one is ever safe." Or more to the point, no investment is ever safe.

--Our view this Monday is Jeremy Cooper's view: avoid complacency. Cooper warned about Aussie banks that still rely on wholesale funding in an article in last week's *Financial Review*. "Its been fashionable for awhile in this country to say the Yanks have blown themselves up and China's now going to be in

the ascendancy. We've been patting ourselves on the back about our regulatory system," he said.
--"Something we did learn out of the [Global Financial] crisis is there is a systemic issue here that hasn't been fixed. It's how the banks fund themselves and their reliance on wholesale funding that hasn't been addressed," he added. Cooper pointed that Aussie banks have borrowed abroad to fund Australia's domestic spending and investing (mostly on housing). This borrowing is what permits Australia to run a pretty regular current account deficit.
--Or, if we may put it this way, Australia's housing bubble is built with borrowed money and if the banks don't find another source of funds (cheap, preferably) already unaffordable house prices will now become even more unaffordable. They may even fall.
--Enter stage right our hero Covered Bonds. If you recall, covered bonds are a type of security sold by a bank to an investor and collateralised by the depositor's money. Instead of promising some other security as collateral for investor capital, the bank promises your money.
--Treasurer Wayne Swan's banking overhaul proposes to let banks sell covered bonds up to a limit of 8% of their total assets. According to APRA, the banking system has just over $1.8 trillion in assets. That means Aussie banks could sell about $145 billion in covered bonds, in aggregate. More money for the housing market, anyone?
--The banks like the deal not because it favours creditors over depositors in a bank failure (although it does), but because it gives them a new pool of cash to lend. Because the bonds are secured by depositors (your money) the interest rates on them (what the bank pays investors) is lower than similar bonds secured by nothing at all.
--So the bank pays less. And this, the bankers assure us, means the banks can continue extending credit to Australian businesses and home buyers. It's win-win, which means no one loses.
--It IS a bit problematic that the covered bond limit is a percentage of assets and not deposits. In the unlikely event of the total collapse of the Australian housing market and the wipe-out of banks, the value of bank assets would fall, mostly because residential and commercial mortgages make up such a large percentage of bank assets. That means the covered bonds issued would be a larger percentage of liquid bank assets (deposits) than the 8% suggests.
--But don't worry. Even if the banks' creditors had access to your deposits ahead of you, the government is the ultimate guarantor of bank deposits via the new Financial Claims Scheme. And even though that scheme isn't funded yet, we imagine the government can always sell its own bonds to the Reserve Bank in order to raise the cash to pay the depositors of the failed Aussie bank.
--What's that? What happens if the Reserve Bank doesn't have the cash? Not a problem! It will just print more. And yes, that will reduce the value of everyone else's savings. But at least the banks will have been able to keep the housing boom going just a little bit longer, even if has the potential to wipe out risk-averse savers.
--Someone has to pay for a credit boom, you know. And it's not going to be the bankers or the regulators who make them possible. Speaking of

regulators, will someone please explain to us the exalted status Ross Garnaut seems to have in Australian public life?
--Mind you, we have nothing against the guy. He's probably amiable and well intentioned enough. But it's the well intentioned do-gooding so-called "public servants" you have to worry about the most. In the name of the "public good," they tend to be the most willing to trash economic and personal liberty.
--In Garnaut's case, he keeps popping up with "expert" papers on climate change. He's an economist by training and a climate scientist by self-belief. Of course you don't have to have a Ph.D to know what you're talking about. Our modern society is too respectful of credentials and not respectful enough of common sense. We won't hold it against Dr. Garnaut that he's an economist holding forth on the climate.
--After all, we're a financial scribe with a degree in liberal arts holding forth on the nonsense of Dr. Garnaut's views. But as a literature major, we also object to his torturous use of the English language. Take this example where he explains why power companies are not entitled to compensation as a result of the carbon tax that he hopes will come into effect next July:
Any fall in asset value stemming from the internalisation of the carbon externality (through pricing carbon) creates no greater case for compensation than other government reforms to reduce other externalities, such as the introduction of measures to discourage smoking, control the use of asbestos or phase out lead in petrol.
--That is prose only an economist could love. And it's thinking only a dullard or an economic saboteur could embrace. It is revealing, though. Garnaut is saying that when the government decides to intervene and arbitrarily raise prices in a market, it gets to decide who is eligible for compensation.
--This is not sound thinking. But it is, in its own way, logical. When the leader of a gang robs a bank, he gets to decide how the loot is distributed amongst the gang. Garnaut is predicting dire climate consequences without a carbon tax. He recently said, "I would now be tempted to say that views that temperatures and damage from a specified level of emissions over time will be larger than is suggested by the mainstream science are much more likely to be proven correct than those that embody the opposite expectations."
--What he really means, we think, is this, "Me and the gang that has hired me to make this tax look urgent and respectable to you (mostly by snowing you under with how accomplished and important I am) are now certain that if we don't tax carbon now the seas will rise and you'll all drown. So shut up and pay up."
--You do have to give the climate con gang credit where it's due. They've correctly understood that the demographic challenge facing the Western world probably means a declining tax base from which to finance their Welfare Statist dreams. With that honey-pot tapped out, they need to find a new one, and right quick.