# Twenty-Five Million Naked Emperors and Empresses

## A submission in response to the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry Interim Report

Submitted by Mr Nathan L. Clark EMBA, MComm

25th October 2018

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# The Reasons for This Submission

From the Executive Summary of the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry Interim Report (Hayne, 2018):

> The Commission's work, so far, has shown conduct by financial services entities that has brought public attention and condemnation. Some conduct was already known to regulators and the public generally; some was not.
>
> Why did it happen? What can be done to avoid it happening again? These are now the key questions.
>
> In this Interim Report these questions – 'why' and 'what now' – are asked with particular reference to banks, loan intermediaries and financial advice, with a view to provoking informed debate about both questions.

I agree with the Commission that these questions are most important. The principal reason for my submission is that it is important to address the cause of the problem rather than the symptoms.

Reviewing the Interim Report leads me to believe that the commission may make a finding or findings which places the emphasis on behavioural factors and will not adequately acknowledge the root causes; I believe that the commission can be swayed by anecdotal evidence provided to the commission, rather than looking at all of these problems in the macroeconomic context, and the commission may determine that simply greed is the problem and the solution is simply better or more regulation.

It is critically important that we look at the origins of these systemic problems and understand that the problem is not simply greed, and that the solution is beyond restructuring regulatory frameworks; The problem's origins are in the economic policies formed over many governments with the singular purpose of inflating and maintaining a series of unsustainable property bubbles.

The formation of these property bubbles has been deliberate, a concerted effort between the polity, the banks, the property developers, a self-interested media deriving huge revenues from property advertising, but most treacherously by the institutions responsible for regulatory oversight, particularly the Reserve Bank of Australia by creating the third property bubble, and the Australian Prudential Regulation Authority. What enables these bubbles has allowed so much other misconduct in the banking, superannuation and financial services industry.

A secondary reason for this submission, and arguably much more important in outcome, is that I believe the recommendations of this commission will be nation changing. The Commission is already changing the direction of the nation by its very existence in the national psyche - **people know something is going to happen**. This is an opportunity for the nation to take a step back and realise that its collective lived experience has been inside a bubble, a bubble with definite and predictable mathematical limits. As those limits are exceeded the consequences become both economic and existential. There will be a legion of people feigning ignorance, declaring “who could have possibly seen that happening at the time, now we have the wisdom of hindsight, of course that’s what has happened.” This is extremely dishonest. The present situation and the future situation are, and always were, entirely predictable.

The Commission could spend the next eternity investigating the last twenty something years of economic and financial malfeasance and I want this submission to provide context when the investigation ends, and it must end, a context in which practical solutions might be employed and what form they might take.

I sincerely hope for prosperity for all Australians, beneficiaries of its natural wealth through the dumb luck of having been born here, and beneficiaries of the prosperity enterprise can bring us all through a properly managed, productive, non-speculative economy.

Sincerely,

Nathan L Clark EMBA, MComm
25th October, 2018.

# Executive Summary

- The investigations of the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry are limited to submissions of experiences. Together these will form a narrative describing unethical and criminal behaviour.
- The motivations are the usual suspects of greed and laziness, but that does not explain how they are facilitated.
- Regulation and oversight is clearly a problem, but the regulatory bodies have demonstrated an inability to manage the biggest enabling factor, which is the huge debt bubble created by no less than three property bubbles.
- The formation of these property bubbles has been deliberate, a concerted effort between the polity, the banks, the property developers, a self-interested media deriving huge revenues from property advertising, but most treacherously by the institutions responsible for regulatory oversight, particularly the Reserve Bank of Australia by creating the third property bubble, and the Australian Prudential Regulation Authority.
- The RBA and APRA have escaped all scrutiny for their role as enablers of financial malfeasance so far, this submission seeks to redress that, and identify the active roles they have played in this misallocation of our nation's productive resources and the future wealth of younger Australians.
- The level of financial literacy amongst Australians is very, very low, and has more in common with a religious belief system based on the false premise that property values double every seven to ten years.
- With depressed wages and increasing costs of living many households are experiencing their own "Personal Recession" which is being hidden by headline macroeconomic figures such as GDP and a polity that celebrates "27 years of uninterrupted growth" which has simply been achieved by importing record numbers of people through the adoption of a mass immigration. The net effect is the microeconomic conditions of households is deliberately, and perilously being ignored by governments and institutions charged with the sustainability of our economy. This is leading us to a Deflationary Trap.
- We don't need to give the regulators more power considering how they have demonstrated two decades of economic corruption, we need new regulators and the macroeconomic tools also need significant reformation.
- A comprehensive summary of recommendations is made at the bottom of this submission.

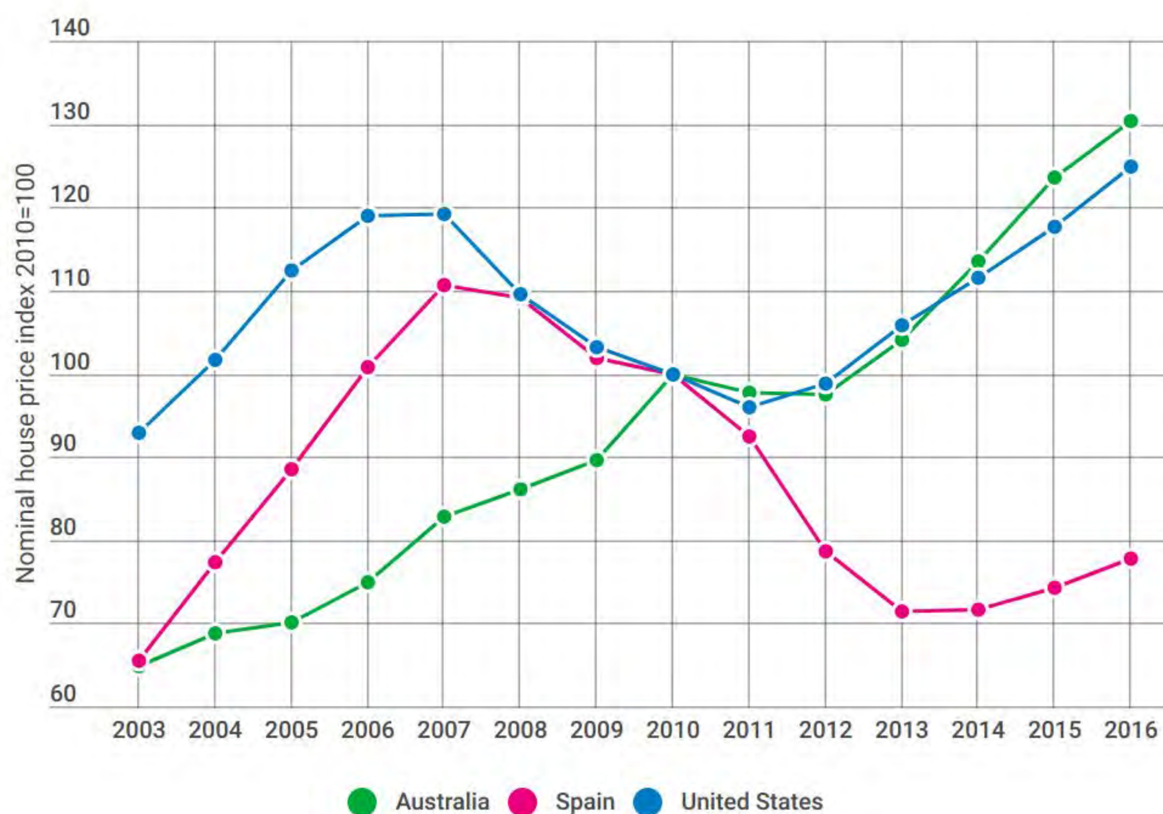
Most of my recommendations form the basis of economic policy, and are beyond the recommendations this Commission is likely to make. There are particular recommendations I think would server everyone well. The first is making transparent the finances and wealth of the public servants who influence and make economic policy, and their families. The second is the implementation of the anti-money laundering laws that, bizarrely, real estate finds itself exempted from. The third and final one is to call forward the Governors of the RBA, RBA board members, the APRA Chairpersons and key staff, and the Treasury Secretaries who oversaw and encouraged the creation of these trillions of dollars of money from debt. It is these trillions of dollars which flowed through the rest of the financial system creating buckets of money which drove the greed this Commission is investigating. Overall this debt bubble and the crimes the Commission are investigating amount to a transfer of wealth from people who have to yet to earn it, that is if they will earn it at all, to people who didn't earn it but have an unjust right to it.

# This is our Economy - Three Property Bubbles Stacked on Top Each Other

On the 4th of August 2017 an article was posted on the news.com.au website titled “If disaster does strike, here’s how to get out unscathed” (Murphy, 2017)

It came about in a media that began to split down the middle, with a small voice saying “there might be a property bubble” and a much larger voice saying “there is nothing to worry about. Property doubles in value every seven to ten years.”

Despite the title, **the article presented a very dishonest graph** showing three different property markets; Australia, Spain, and the United States of America.




(Murphy, 2017)

What makes this dishonest is the way the data is presented.

The authors of this graph index all prices at 2010. Let’s consider this graph in the way it is presented to us. It shows:

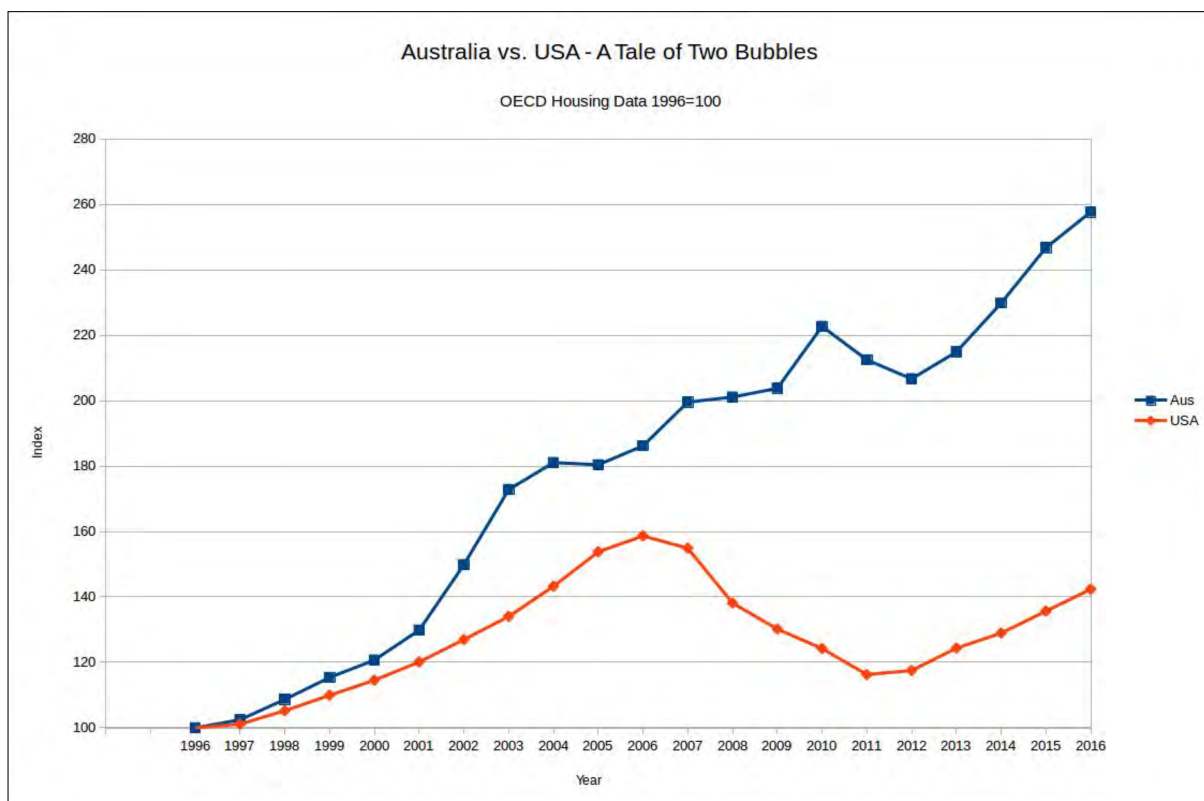
- the USA property bubble climbing from 2003 to its peak in 2007
- Australia and Spain starting at the same level in 2003

- Spain's property bubble also rising to its peak in 2007
- Australia has a gentle, near linear incline

The author indexing the different nation's housing prices in 2010 is dishonest because the Australian economy had miraculously survived the Global Financial Crisis while the USA and Spain were in the depths of financial armageddon. This dishonest graph, typical of a media heavily dependent on advertising revenue from real estate, is comparing apples to oranges.

I took the EXACT SAME OECD data set and set the index to 1996, when the economies of the USA and Australia were similar, and which is also the beginning of the Australian Hyper Triple Property Bubble.

Remember, **this is the exact same data**, and, unlike the news.com.au graph, it is comparing apples with apples.




(Clark, 2017)

Firstly, it looks nothing like the dishonest graph presented in the media.

It shows the three property bubbles stacked on top of each other.

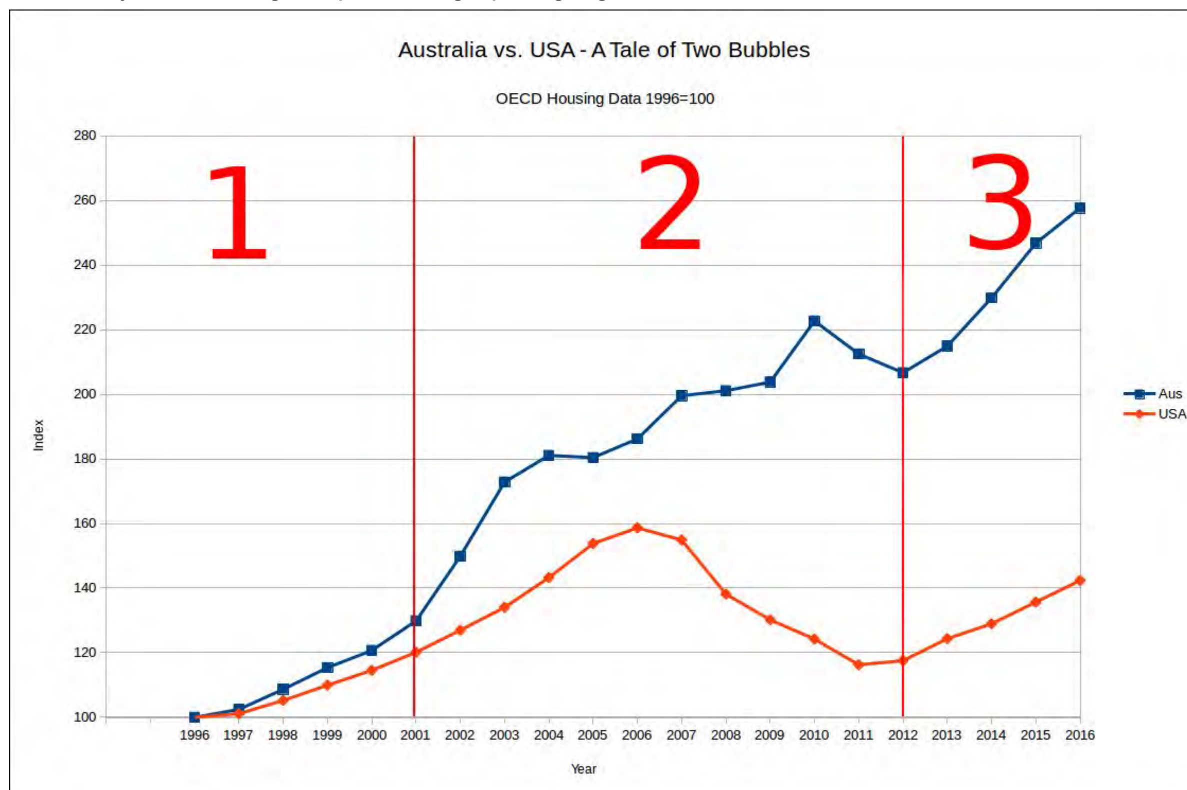
At the height of the gigantic USA property bubble, Australia was already well ahead and halfway into its second property bubble.

The massive downward correction the US property bubble did not find its bottom until 2011/2012, at which it began to recover at the same time the Australian Hyper Triple Property Bubble entered into its third bubble.

The difference between the red line of the USA and the blue line of Australia is gargantuan if we index in 1996 but nearly the same if we index in 2010. The full risk, if realised, is that the blue line comes all the way down to the red line. Up to 80% of the value of house purchased at the top of the Australian Hyper Triple Property Bubble is at risk of disappearing. The danger this presents to the capitalisation of Australian banks is extreme. In the event of a collapse of the three property bubbles, the Australian banks will be encumbered by non-performing loans, will find themselves grossly undercapitalised, and will need to be recapitalised most likely through the seizure of deposits, including the monies held in mortgage offset accounts. The terms and conditions of deposit accounts means that new terms and conditions can be issued prior to the opening of the banks, **terms and conditions which allow a bank bail-in**, where the monies in those accounts are used to meet the capital ratios set by the prudential authority. The government guarantee for deposits is still valid, it's just that the institutions will prevent deposit holders from withdrawing their money.

## Australian Hyper Triple Property Bubble? Three Bubbles? Really?

Absolutely. Demarking the previous graph highlights the bubbles and makes them easier to see:




(Clark, 2018)

This is when they started and why:

### Bubble #1: 1996-2001 – The Tax Change Investor Bubble

- The important preludes of interest rates continually falling from their peak in the early 90s and the privatisation of the Commonwealth Bank of Australia.
- Changes to tax to encourage property investment.

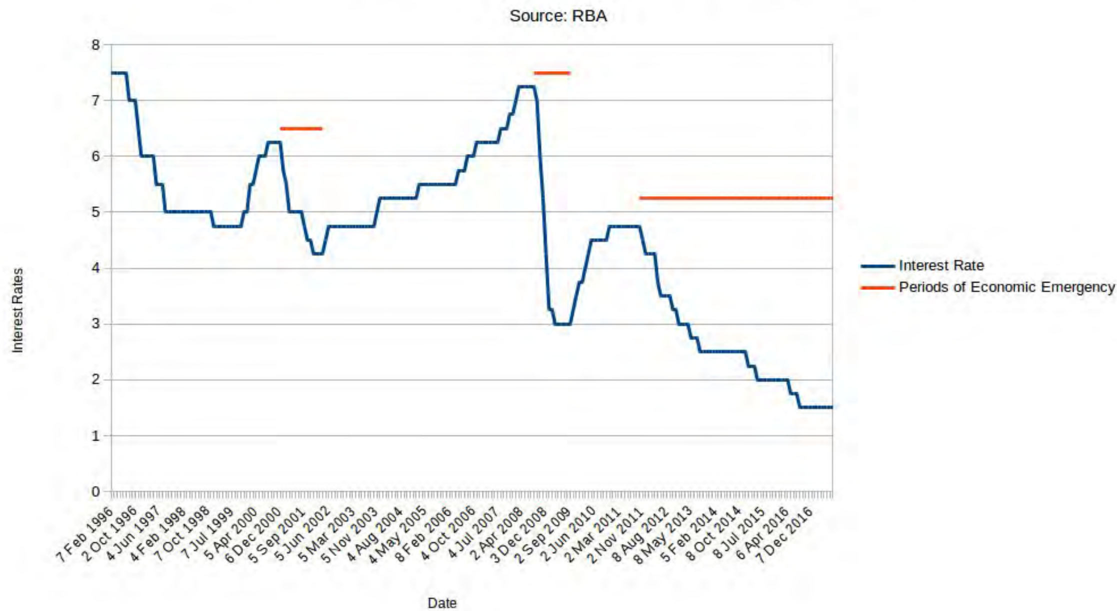
- A cashed up, recovered from the recession, massive cohort of Baby Boomers begin to compete against their children in the property market.
- Howard Australia adopts a mass immigration policy to boost the nation's population.
- The Australian Greens change their focus from a sustainable population level to the feel-good politics of opposing One Nation's xenophobia fearing Australia would overrun by Asians. This provides a green light to Big Australia and the nation begins its journey to rapid population growth.

## Bubble #2: 2001 – 2012 – The Welfare Bubble

- All levels of government start to hand out welfare in the form of housing grants to "help" which juices prices.
- Howard Australia adopts closed borders just for refugees immigration policy while maintaining open borders for economic, skilled, migrants.
- Howard Australia allows borrowing in Self Managed Super Funds - creating new demand for credit where none had existed before.
- Rudd Australia continues welfare momentum along with State governments.
- Gillard Australia continues welfare momentum along with State governments.
- Growth of foreign ownership of residential property at record levels, and becomes a significant percentage of transactions. By 2016 one in four properties purchased in Sydney is by a Chinese national, and one in four of those transactions is paid for fully in cash.
- One Nation switches xenophobia from Asians to Muslims, counter politik delivers Yassmin Abdel-Magied and the politics of youth shifts from equity politics to identity politics. Opposing extraordinary foreign interference in our domestic affairs, including the purchase of residential property, is likely to result in accusations of racism. This is used to shut down debate about both immigration and foreign ownership of residential property.

## Bubble #3: 2012 – 2017 – The Serviceability Bubble

This is the worst of the property bubbles because it was deliberately grown under the management of RBA Governor Glenn Stevens, and maintained by the following RBA Governor, Philip Lowe. Their betrayal is evidenced by the following graph showing the cutting of interest rates which utterly failed to produce increased business borrowing and investment and was entirely captured by growth in private debt to speculate in real estate investment:




(Clark, 2017)

- The Reserve Bank of Australia begins its Zero Interest Rate Policy to provoke the formation of the third bubble. The RBA continually cuts rates, improving the ability to service loans, to maintain this third, terminal, bubble.
- Abbott Australia continues welfare momentum along with State governments.
- Turnbull Australia continues welfare momentum along with State governments.
- Scott Morrison, formerly of the Property Council of Australia, becomes Treasurer of Australia demonstrating the property lobby's infiltration of politics starts at the top.
- Federal politicians own $300m of properties, State politicians billions more, their friends and family billions again. The self interest of politicians alone accounts for billions in property.
- Self Managed Super funds purchase hundreds of billions of dollars of property converting Super savings into deposits for property speculation.
- Politicians such as Nick Xenophon, a prolific property investor and property developer, agitate for use of regular Superannuation to be used to buy property.
- Additional policies enacted to encourage foreign ownership.
- Identity politics become more important to young people than their standard of living and their own future.
- Banks allow 15-year Interest Only loans, allowing ponzi financing to the masses where refinancing in the rising market allows ever bigger loans, which allow people to use the extra loan size to pay a deposit on the next over valued property creating a ponzi finance cycle. Even if the additional finance isn't used to service the current loan, it effectively services the deposit requirement for the next loan;
- **People on meager incomes can amass double-digit property portfolios and millions of dollars of debt**.

## Why the massive sustained cuts in interest rates? What is this economic emergency we are in which justifies them?

With the exception of the Great Depression of 1929 - 1939, no recent real economic emergency has ever lasted this long. The RBA has deliberately mismanaged monetary policy to maintain the property bubble, providing the settings for the longest manufactured economic emergency ever experienced by our nation, running near on seven years with no end in sight. Compare our central bank's efforts to keep the property bubbles afloat with the Marshall Plan which rebuilt western Europe after the destructive second world war. **The Marshall Plan only cost $142 billion in 2016 dollars and only took four years to execute.** The lost productivity caused by our property bubble can only be calculated at the conclusion of the bust, but it will tally in the many hundreds of billions to trillions of dollars. The scale of the betrayal of our central bank is as gargantuan in size as the size of the bubble itself.

Before the conclusion of this Royal Commission we have had several shots fired at this Royal Commission by the governor and one of the RBA board members.

A strategic leak to the Australian Financial Review by journalists John Kehoe and James Frost on the 1st of October 2018 contained the following caution to this Royal Commission. I reproduce the article in full with my highlighting of the cautions made to this Royal Commission (Kehoe and Frost, 2018):

> The Reserve Bank of Australia and Treasury have privately cautioned the Morrison government that any regulatory response to the financial services Royal Commission must be careful to avoid putting the brakes on lending to home buyers and business.
>
> The advice from two of the country's top financial policy agencies appears to partly explain why Treasurer Josh Frydenberg has signalled he must balance cracking down on nefarious misconduct in the industry and ensure credit keeps flowing to borrowers to grow the economy.
>
> The Treasurer has said he also wants to make sure any new rules don't inhibit competition - such as from mortgage brokers - against the big banks.
>
> Sources said the RBA and Treasury had confidentially emphasised to the government the importance of avoiding a credit squeeze.
>
> The royal commission's damning revelations into the financial sector have made some banks more apprehensive to lend in recent months, bankers and small business said.
>
> Royal commissioner Kenneth Hayne and the federal court both recently called into question the validity of the financial models

banks use to assess the expenses of borrowers to determine if and how much to lend to an applicant.

Saul Eslake, a former commercial bank economist, said the Hayne inquiry should focus its recommendations on addressing the shocking misconduct against customers in wealth management, financial planning, insurance and superannuation.

"The royal commission hasn't really shown systematic imprudent lending and borrowing of the sort that was at the heart of the US financial crisis," Mr Eslake said.

"But it does seem the banks are paying more attention to the details borrowers are providing, which could perhaps lead to a credit squeeze.

"It would not be desirable for there to be regulatory-led constrictions on the supply of credit to would-be home buyers or businesses."

"But based on what Hayne seems to be foreshadowing, I don't think he's going to recommend that."

Australian capital city dwelling prices have fallen for 12 consecutive months, Corelogic data published on Monday showed. National prices are down 3.7 per cent from their peak, with Sydney (-6.2 per cent) and Melbourne (-4.4 per cent) leading the slide after years of strong price growth.

Reserve Bank of Australia governor Philip Lowe told the House of Representatives economics committee in August that the slowing in the housing market had reduced demand for credit by investors.

"There has also been some tightening in the supply of credit, partly in response to the royal commission, although the main story is one of reduced demand," Dr Lowe said at the time.

He said the average variable interest rate paid by borrowers was about 0.10 of a percentage point lower than a year ago and "you would not have expected to have seen this if supply constraints were the main reason for slower credit growth".

One business banker said there had been a "capital strike" by medium-sized companies turning over up to $100 million a year in the last two months.

He blamed the reduced demand for commercial loans on domestic political uncertainty approaching the federal election, the

US-China trade war, the royal commission and anti-business rhetoric from Canberra.

UBS bank analysts on the weekend heightened their warning of the risk of a credit crunch in response to commissioner Hayne floating the prospect of stricter expense verification for borrowers and new obligations for lenders to small to medium businesses.

UBS analyst Jonathan Mott wrote to clients on Saturday morning and warned them to expect a prolonged period of crimped bank profits following the release of the banking royal commission's interim report on Friday afternoon.

"The risk of the current credit squeeze turning into a credit crunch is real and is rising, in our view," Mr Mott noted.

"We believe the Australian banking sector is facing a period of substantial and sustained earnings pressure which is likely to last several years."

Opposition treasury spokesman Chris Bowen said on Sunday access to credit was important to the functioning of the economy.

"Now we saw some instances in the royal commission where clearly inappropriate credit was provided but nobody would suggest that there needs to be a crackdown on legitimate credit and this is something the royal commission has to work through, this is something a government implementing the recommendations would have to work through," he said on Sky News.

Mr Bowen has called for the commission's deadline to be extended beyond February to allow more time for consultation with the industry's stakeholders and to give victims more opportunity to voice their stories.

S&P Global Ratings said on Monday the interim report by the royal commission had no immediate impact on Australian bank ratings.

"We note that the interim report, released on September 28, 2018, does not contain any recommendations, but highlights in detail a number of issues related to conduct, culture, and governance prevalent in the Australian financial system," S&P said.

The opening of the Australian Financial Review article provides directive to the Royal Commission to follow, and is supported by assenting commentary. There is, of course, counter-commentary but it has been omitted from the article. This submission I am making seeks redress to what has been largely absent from the media for the past two decades, facts from data.

This article does not appear in isolation. RBA board member Ian Harper made note to the Washington Post on the 14th of October 2018 as reported by David Scutt in Business Insider 15th October 2018 :

> Ian Harper, Reserve Bank of Australia (RBA) Board member, has warned a near-term increase in official interest rates could "spook" Australian households, increasing the risk of a pullback in spending at a time when home prices are falling and wage growth is weak.
>
> "The best contribution the bank can make at this juncture is to do what they are doing, which is just to sit and make it quite clear what the logic is, and give a sense of where the economy is headed," he said in an interview with the Wall Street Journal.
>
> He added that the RBA's recent mantra on supporting confidence and stability in the economy "is the right story", referring to the view offered by the bank that steady interest rates should be regarded as "source of stability and confidence".

On the one hand, Ian Harper is warning that a tiny upward change in interest rates will spook households, yet he is averse to commiting to the change the RBA continually indicates is coming, namely that global rates are moving upwards and ours might too.

The RBA's own report for October 2018 says:

> Members observed that while the regulators had already overseen a tightening of lending standards, and a degree of tightening of lending standards had been implemented by banks in anticipation of the Commission's findings, it was possible that banks could tighten lending conditions further given the issues raised in the report

I believe these are our dishonest central bank's own submission to the Royal Commission, whispering in the halls of power to concert other institutions to prepare to protect the bubble, rather than a direct submission to the Commission and waiting for the Commission's recommendations. On queue, Federal Treasury prematurely prepares a "task force" even though it hasn't been tasked with anything (SBS, 2018):

> Treasury has established a task force to help the federal government respond to issues raised by the banking royal commission.
>
> Secretary Phil Gaetjens told a Senate estimates hearing that Treasury recently created the task force to help the government deal with the serious problems raised in the interim report, released last month.

> "It is clear that once the royal commission hands down its final report, due by the first of February, that there will be more work to do," he told the hearing in Canberra on Wednesday.

This submission frames these actors for what they are, producers of disinformation to protect the status quo and hope that the three bubbles can stay inflated for just a little longer, and that someone else might fix this wicked problem or some external event trigger the collapse and that can be pointed to as the cause of our economic woes rather than their own dishonest conduct.

The fact is, the RBA's unofficial policy, certainly outside of its mandate, is to protect the property bubble all the way down to an interest rate of 0%. They will cut interest rates because they are captured by the bubbles they themselves have made.

There was public discourse on the existence of a property bubble and the RBA provoking the third bubble on top, and the RBA's adoption of a Zero Interest Rate Policy as far back as 2012. Michael Janda at the ABC wrote in an article titled "As the mining boom ends, the housing boom begins" (Janda, 2012):

> 4 Oct 2012, 7:30am
>
> The RBA could find itself with a housing bubble just as Australia's resources boom starts to fade in earnest, writes Michael Janda.
>
> Amid the now regular commentary on fragile international financial conditions, and some genuine concerns about slow credit growth and the state of the domestic employment market, two things stood out in the the Reserve Bank (RBA) governor's post-meeting statement yesterday.
>
> The first, and most widely discussed by the financial press and commentators, is Glenn Stevens' fresh assessment of the mining boom, or end thereof.
>
> "The peak in resource investment is likely to occur next year, and may be at a lower level than earlier expected," he cautioned.
>
> The RBA had already pulled back its expectations of the mining investment peak to sometime next financial year (July 2013-end of June 2014) as recently as August.
>
> However, the governor's statement seems to pull this even further back to some time next calendar year.
>
> The bank's previous expectation was for falling mining investment to subtract from economic growth sometime the year after next, so presumably it is now expecting that to start before the end of next year.

A related factor in the decision to cut was the fact the Australian dollar has not yet reflected this new resources reality of falling commodity prices and soon to be falling investment.

The bank's decision to act has already shaved more than a cent off the local currency against the greenback, but such a decline is still miniscule compared with the fall in commodity prices, which are off around 15 per cent over the past year.

In fact, the dollar has increased relative to international benchmarks over that period, with the fall in commodity prices 18.5 per cent in Australian dollar terms.

As many economists noted yesterday, the Reserve Bank is taking out more insurance against this mining-sector weakness by trying to kick-start areas of the economy that had been slowed down as part of the longer-term 'structural adjustment' to the mining boom.

"As this peak approaches, it will be important that the forecast strengthening in some other components of demand starts to occur," Mr Stevens observed.

The other standout in the governor's statement was something that was not in it - the notable absence of any comment on home prices.

This absence was notable because the Reserve Bank has recently taken to a running commentary on dwelling values and the effect of interest rates on them.

The comment in February was: "Housing prices showed some sign of stabilising at the end of 2011, after having declined for most of the year."

March brought a similar statement, which was repeated verbatim in April: "Housing prices have shown some sign of stabilising recently, after having declined for most of 2011, but generally the housing market remains soft."

In May, after slashing rates by 50 basis points to 3.75 per cent, Mr Stevens still noted: "Housing prices have shown some signs of stabilising recently, after having declined for most of 2011, but generally the housing market remains subdued."

The RBA cut rates again in June, noting a deterioration in the property market: "Housing prices had shown some signs of stabilising around the turn of the year, but have recently declined again. Generally, the housing market remains subdued."

A modest improvement in house prices had the RBA saying in July: "The housing market remains subdued."

August saw the Reserve Bank noting that mortgage interest rates sitting below average were starting to have an effect: "While it is too soon to see the full impact of those changes, dwelling prices have firmed a little over the past couple of months."

In September, the bank said its sequence of earlier rate cuts was boosting housing market activity: "The impact of those changes is still working its way through the economy, but dwelling prices have firmed a little."

Yet in October, on a day when the home price index that the Reserve Bank seems to pay most attention to recorded its biggest monthly increase in dwelling values in two-and-a-half years, silence.

For the first time this year, no mention of home prices.

The closest Mr Stevens got was an acknowledgement that, "Interest rates for borrowers have for some months been a little below their medium-term averages. There are tentative signs of this starting to have some of the expected effects."

Presumably one of those "expected", but not desired, effects is a boost for property prices.

But Mr Stevens appeared to take the Basil Fawlty approach - "Whatever you do, don't mention the war."

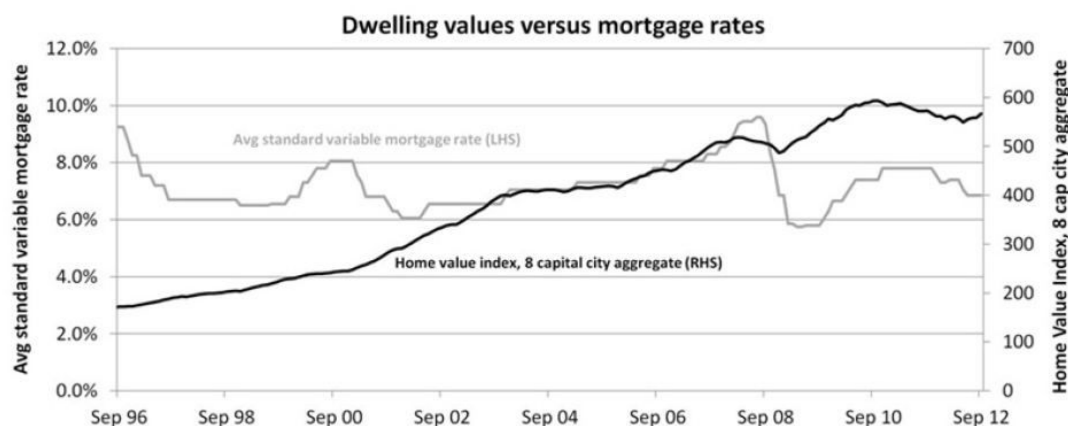
For, make no mistake, the Reserve Bank in its statements, speeches and even a rare public appearance by the governor on breakfast television a few years back has been waging a low-key battle to keep Australia's property market in check.

There is no property bubble, the bank has repeatedly stated, yet it has equally frequently warned that the kinds of home price gains seen during the early 2000s cannot be sustainably repeated.

Rather, the RBA's preferred outcome would be a period of relatively stagnant home prices that allow incomes to catch up and improve affordability, without having the negative economic flow-ons of a rapid real estate crash such as in the United States.

Perhaps then the reason that Glenn Stevens conspicuously did not mention home prices yesterday is that the recent surge highlights the danger of the bank's current course of cutting rates.

That danger is well-illustrated in the graph below that shows how a string of rate reductions is generally associated with an acceleration in the rise of home prices.




While it is true that rising rates failed to stop the acceleration in home prices in 2006 and '07 until average mortgage rates hit 8.5-9 per cent, it is clear from the graph that home prices do tend to accelerate after rate cuts.
Look at late 2000 and 2001, when rates cuts (and, it must be said, generous government subsidies for certain groups of home buyers) saw home prices accelerate.

The same effect recurred during the first phase of the global financial crisis in late 2008 and through 2009, causing dwelling prices to jump more than 20 per cent in two years.

The early stages of a similar trend are already becoming apparent in the graph, coinciding with the Reserve Bank's latest series of cuts starting in May.

Such a trend makes sense, with people saving in the bank for a housing deposit seeing their interest rates cut while at the same time seeing the interest rates on a potential mortgage fall, temporarily improving the affordability of buying.

The danger is, once rate cuts start a wave of property buying, that wave grows as people increasingly fear being locked out of the real estate market if they do not buy now.

> This fear is quite real when first home buyers see home prices rising at a faster pace than the interest on their savings, thus seeing the purchasing power of their future deposit shrink as it languishes in the bank.
>
> That could go some way to explaining why it took so long, and so many rate rises, for the housing market to slow down in 2007 and 2008.
>
> The problem is that not acknowledging the risks of one's actions does not make those risks disappear.
>
> There is a real danger that this month's rate cut - and the one, two or three more many economists expect - will rekindle the problem of elevated housing prices, which was far from extinguished by the modest real estate fall last year.
>
> Then the RBA might really find itself with a housing bubble and a lot of over-indebted buyers right at the same time that Australia's resources boom starts to fade in earnest.
>
> If a fall in the Australian dollar starts adding more pressure on inflation, the Reserve may find itself with much tougher rates dilemmas over the next couple of years than the difficult situation it already finds itself in.
>
> Failing to acknowledge the dilemmas won't make the choices any easier.

Here we have a journalist describing a schizophrenic RBA, upset there are already two property bubbles, but panicking that the collapse of the mining boom might collapse those bubbles quickly, so it embarks on the path of blowing a third property bubble. This strategy beggars belief.

## 2017 – Peak Serviceability

Throughout 2016 I wrote continually to friends and family warning them of the end of the property bubbles. I referred to the top of the bubble as “Peak Serviceability” where the nation was exhausted of the ability to service any more debt. I called the top of the property bubble for these reasons:

- The Bank of Mum and Dad has become the fifth-biggest lender in the country
- Changes in Interest Only loans makes ponzi financing very hard
- The absence of ponzi financing from Bank lenders arrests house price growth in the capitals
- Wage growth is dead in the water
- The cost of living continues to rise and discretionary spending begins to evaporate
- Australian car industry stops production

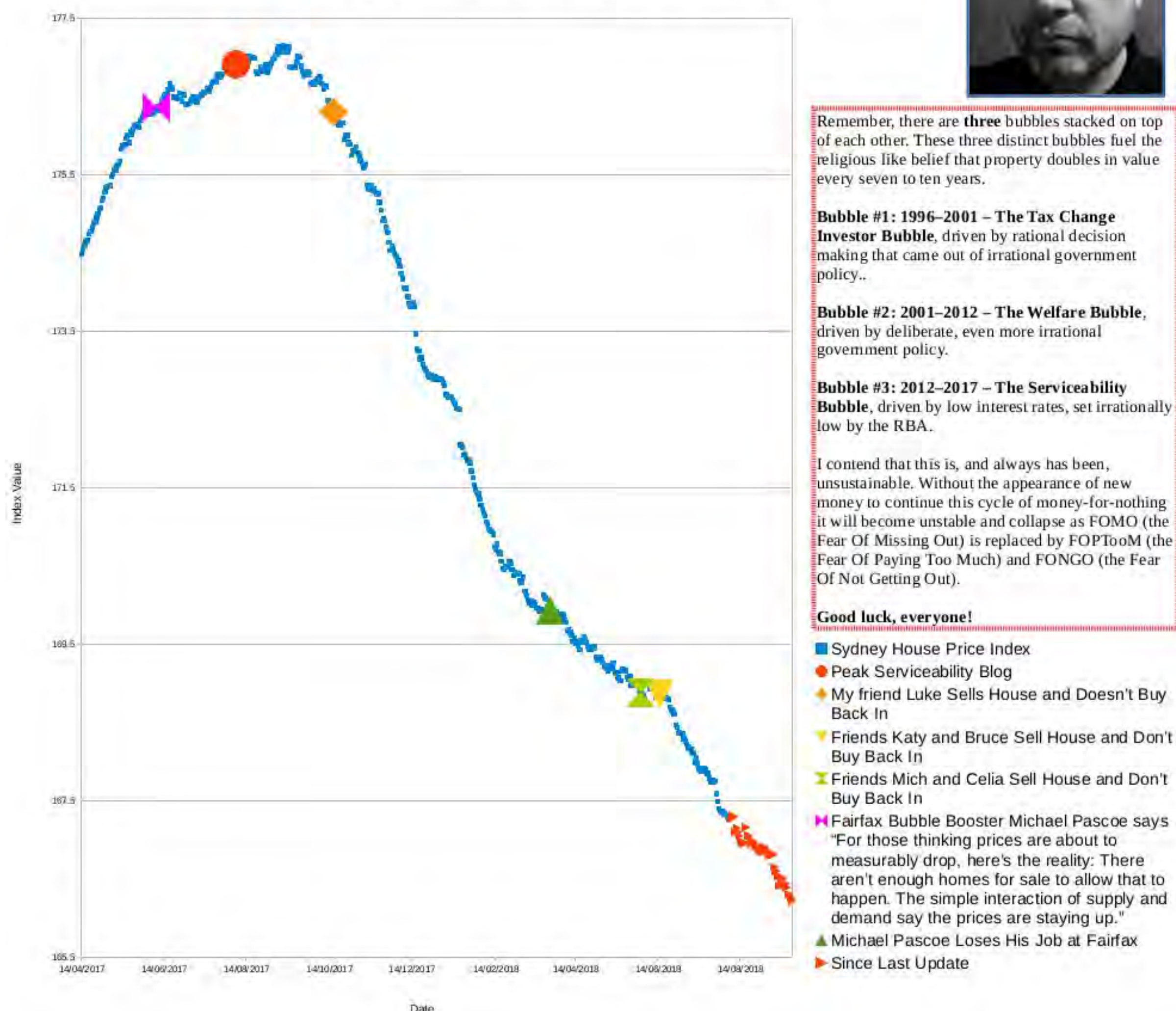
- Plans begin to use Superannuation outside of SMSF to buy property
- The Bank of Mum and Dad is huge. Mum and Dad are our subprime lenders. A decade ago they were helping out with $10K, now they're kicking in ~$90K.

Some of my friends, of their own volition from their own decision making and independent inquiry, came to the same conclusions as me and made the decision to sell their houses.

The bizarre behaviour of people wanting to accumulate record levels of debt seemed to reach a crescendo, with people paying ever more, yet earning ever less. To me, households looked like they were hyperextended in debt inside a hyper bubble. I wrote a blog where I called “Peak Serviceability” coming about because, despite the headlines of our uninterrupted growth, household finances were breaking left right and centre and millions appear to be in a “Personal Recession.” That is, what the headlines say doesn’t matter anymore. What the lived experience is, is the only thing that matters, and the lived experience is:

- A massive increase in underemployment caused by massive, unplanned and unsustainable growth in population.
- Wage depression, caused by unfair changes in labour laws and also by unplanned and unsustainable growth in population.
- Rises in the cost of living, caused by the massive costs imposed on the citizenry through two decades of privatisation, and also by the competition for housing and other resources as a direct result of unplanned and unsustainable growth in population.

I was accurate with my calling of the top of the bubble with my blog post about “Peak Serviceability” and the market has began to fall. Looking at the CoreLogic housing data the direction on the fall seems inexorable. You can see from this graph that the Sydney market, ground zero for the collapse began in August 2017. The following graph charts the fall in Sydney house prices:



(Clark, 2018)

This bubble is bursting while we're still being told the economy is in great condition with record numbers of jobs being created and a fall in unemployment. The concept of what a job is, and what is an accurate measure of unemployment has not kept up with changes in the nature of employment, we have move to insecure casualised employment, or the fact that underemployment is a better measure of economic stress felt by the masses rather than unemployment since the nature of employment has changed. These changes are generational, with people born after 1980 having an entirely unrelatable experience to those born before 1965. We have two distinct populations, existing as generations, with wildly distinct experiences. The older generation have formed their view of the world and it does not match the experience of the younger generation. There is one thing they do have in common, and that is a poor comprehension of financial literacy.

# The Financial Illiteracy of the Common Australian

Australians have a demonstrable problem with financial literacy.

Financial literacy is the education and understanding of various financial areas including managing personal finance, money and investing.

Financial literacy also involves the proficiency of financial principles and concepts such as financial planning, compound interest, managing debt, profitable savings techniques and the time value of money. The lack of financial literacy may lead to making poor financial choices that can have negative consequences on the financial well-being of an individual. If many people are making poor financial choices then the negative consequences are magnified economy wide, reflected in declining consumption. If many people are making poor financial choices that are leverages with debt, then a multiplier effect causes massive economic damage and can plunge a nation into economic ruin.

Financial literacy helps individuals become self-sufficient so that they can achieve financial stability. Those who understand the subject should be able to answer several questions about purchases, such as whether an item is required, whether it is affordable, and whether it an asset or a liability.

This field demonstrates the behaviors and attitudes a person possesses about money that is applied to his daily life. Financial literacy shows how an individual makes financial decisions. This skill can help a person develop a financial road map to identify what they earn, what they spend, and what they owe.

Instead of financial literacy we have a financial factoid in its place. A factoid is either a false statement presented as a fact or a true, but brief or trivial item of news or information. The factoid is:

**Property Investments Double in Value Every Seven to Ten Years.**

I have heard this mentioned by so many people, in so many places, and spoken about so zealously it might as well be the mantra of a state religion. People's belief in this false statement has made it something of a self-fulfilling prophecy, but the principal driver of giving this factoid the appearance of validity has been the crafting of policy and the concerted effort of policy influencers to maintain this illusion. The deception of the financially illiterate Australians has been conducted by governments, the central bank, and regulators alike. Financial literacy, or it is probably better if referred to as financial illiteracy, is the vector which has been exploited by those the commission has been investigating.

The government set up a bureaucracy to improve financial literacy. From Financial Literacy Australia's website http://finlit.org.au/about/:

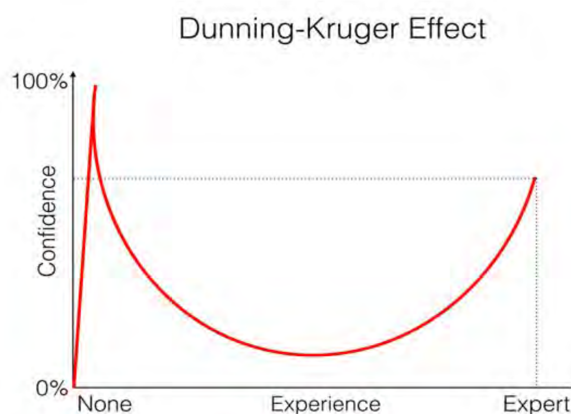
> Financial Literacy Australia Limited (FLA) is a not-for-profit organisation founded in 2012 by members of the government's

```
Financial Literacy Board. Its mission is to advance financial
literacy in Australia.

Our primary program is the Financial Literacy Australia Grants
program to boost financial literacy programs and research in
Australia. This started in 2014.

From 2012 to 2014, we also coordinated the national consumer
awareness campaign MoneySmart Week to promote the importance of
financial literacy.

More broadly, FLA encourages cooperation between corporate,
government, community and education sectors within the financial
literacy community. Our work helps to advance the National
Financial Literacy Strategy.

Board and staff
Meet the Board of Directors and staff. The Financial Literacy
Australia Grants program is overseen by a sub-committee of the FLA
Board.
```

This entity does not actually produce anything to help with financial literacy of our people, but instead issues grants which fund projects which might target specific people. None of the projects funded provides the masses with a better understanding of their finances in the context of the broader economy outside of their personal finances. None of the funded projects increase people's understanding of the property bubble. None of the projects funded do anything to address the belief system based on the falsehood that property prices double in value every seven to ten years.

## The Dunning Kruger Effect Helps Explain Our Financial Illiteracy

In the field of psychology, the Dunning–Kruger effect is a cognitive bias in which people of low ability have illusory superiority and mistakenly assess their cognitive ability as greater than it is.




(Frost and Nunan, 2018)

People of very limited financial competency who have seen others experience the wealth of the bubble, or who have experienced the bubble themselves have very high levels of confidence in the financial decisions they make. They have neither risk acceptance nor risk aversion - they have ignorance of risk, they are entirely ignorant to risk and cannot make a competent decision.

The finance sector has long used this ignorance and lack of competence in its marketing strategies. People are not being given sound financial advice, they are being marketed to.

Early examples of the exploitation of the ignorance and incompetence can be found in the 1990s.

The freshly privatised Commonwealth Bank ran for several years the “Equity Mate” ads.

(Commonwealth Bank of Australia, 1996)

A car arrives with an angry wife jumping out and running inside. The neighbour in his new boat suggests they need to go on a holiday. The man asks his rich neighbour how he affords all these holidays and new boats. The rich neighbour’s response is “Equity, mate!”

These ads provide a marker in time for when the nation embarked on creating a massive debt bubble, almost all of which has been blown into the three property bubbles.
At the time of these advertisements Australia’s private debt levels to GDP were 120%. Since then the nation has embarked on a frenzy of debt and private debt levels are at 205%.

(Trading Economics, 2018)

The change appears to be an increase of 85% but it is much higher when you consider the growth in the GDP.

It is important to note that the nation's GDP has grown as well. This means the differential between the change in value of GDP and the change in private debt has widened providing a ratcheting effect.

| Year | GDP (in Bil. US$ PPP) | GDP per capita (in US$ PPP) | GDP growth (real) | Inflation rate (in Percent) | Unemployment (in Percent) | Government debt (in % of GDP) |
|---|---|---|---|---|---|---|
| 1995 | ▲414.8 | ▲22,891 | ▲2.9 % | ▲4.6 % | ▼8.5 % | ▲31.2 % |
| 2017 | ▲1,246.5 | ▲50,334 | ▲2.3 % | ▲2.0 % | ▼5.6 % | ▲41.6 % |

(IMF, 2018)

In 1995, the beginning of the Equity Mate Era the GDP was $414.8bn and private debt was $497.8bn

By 2017 GDP was $1246.5bn and private debt was $2555.3bn.

In 23 years we've grown our annual productivity by $831.7bn, but grown our private debt by $2057.5bn

The difference in growth between the change of the two is not 85%, but rather 247%. This is a massive debt bubble. It is gargantuan in size.

Again, it is important to note that this is not one single bubble but three distinct bubbles stacked on top of each other and it's only held together by the financial factoid "**Property Investments Double in Value Every Seven to Ten Years**" still bouncing around inside the heads of millions of financially illiterate Australians even though we've had over one year of losses in the most important real estate market in the bubble.

Evidence of the level of unsophistication, and how widespread that unsophiscation is, can be seen in the number of interest only loans that were taken out. From News Ltd 23rd October 2018 (Molloy, 2018):

> ALMOST one million Australian homeowners will be dealt a serious budget blow at the start of next year, and it could be the struggling property market's "ticking time bomb".
>
> Analysis by comparison website finder.com.au found that of the $706 billion worth of new home loans approved in 2014-15, a worrying 42 per cent of them were for interest-only repayment arrangements.
>
> And more than 900,000 of them will begin expiring from January, reverting to principal and interest payments.

Graham Cooke, insights manager at finder.com.au, said it would add an average of $400 extra per month to repayments.

"This, combined with falling house prices and predictions of an upwards movement in interest rates, could mean that many people are left really struggling," he said.

The interest-only loans granted over the course of 2014-15 were worth $295 billion, the highest on record in the past decade.

Household budgets that are already stretched due to higher cost of living and flat wages growth could find it difficult to manage the increase to their bills.

Mr Cooke said one of the reasons people opted to pay just the interest, rather than reduce the size of their mortgages with principal repayments, was budgetary pressures.

So, people who were already in precarious financial positions might not be well-placed to cover the additional money when their interest-only loans expire and revert.

"For those who wanted to slightly reduce mortgage repayments to take a bit of pressure off, it was an appealing product for borrowers," he said.

"There are a certain proportion of people who made the decision for that reason. Some families will definitely be struggling when the loans revert."

The Australian Prudential Regulation Authority introduced a range of measures to crack down on interest-only loans, concerned by the mammoth growth.

It included capping the number of interest-only loans that banks can issue.

"Lending growth has moderated, standards have been lifted and oversight has improved, however the environment remains one of heightened risk and there are still some practices that need to be further strengthened," APRA chairman Wayne Byres said.

A speech by Reserve Bank of Australia assistant governor Christopher Kent in April warned of the potential impacts of the expiry bomb.

"The step-up in required payments at that time for some individual borrowers is nontrivial but for the household sector as a whole,

the cash flow effect of the transition is likely to be moderate," Mr Kent said.

"Some borrowers may experience genuine difficulties when their interest-only periods expire though."

The most vulnerable were owner-occupiers with high loan-to-value ratios, Mr Kent said.

Adding to the pressure is the falling value of houses. As of September, average home values in Australia's capital cities have fallen 3.7 per cent over the past 12 months.

The biggest declines have been seen in Sydney, where values tumbled 6.1 per cent, and Melbourne, down 3.4 per cent.

Should they be forced to sell, homeowners will walk away with considerably less. And many believe it will only get worse.

The finance agency UBS forecasts total declines of at least 10 per cent and for the softening to carry on for some time, while AMP Capital has tipped reductions of 20 per cent.

In more bad news, the number of households experience mortgage stress — where 30 percent of their income or more goes to home loan repayments — has hit its highest level on record.

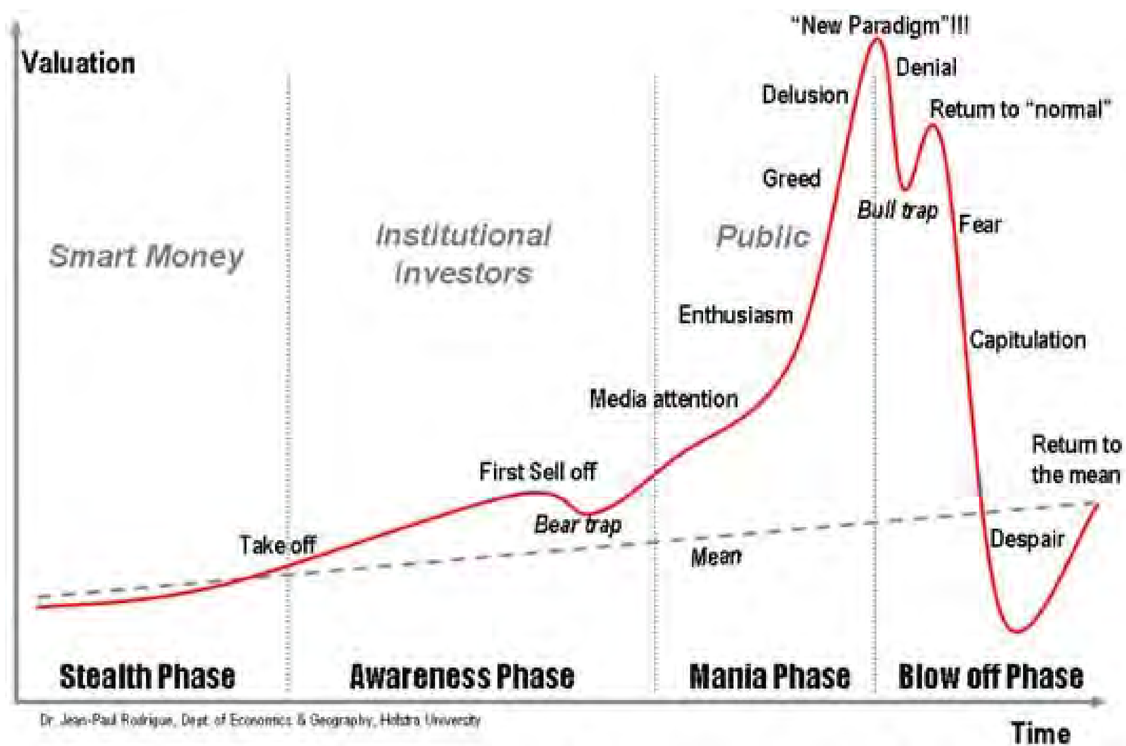
In August, analysts estimated that 996,000 households are experiencing mortgage stress, according to Digital Finance Analytics.

"There are a lot of perfect storms brewing in the housing market at the moment," Mr Cooke said.

"How quickly prices continue to fall will be something to watch closely. It's unclear if it will be a continuous decline or a softer landing."

APRA's changes are too little, too late. APRA chairman Wayne Byres' quote should draw special attention "Lending growth has moderated, standards have been lifted and oversight has improved, however the environment remains one of heightened risk and there are still some practices that need to be further strengthened" because this suggests that standards were inadequate and oversight lacking in the twenty years of the growth of these three bubbles. APRA is as accountable as the banks and the central bank.

No bubble in history has ever experienced a soft landing. In fact this is the generally accepted curve of what happens when a single bubble collapses.



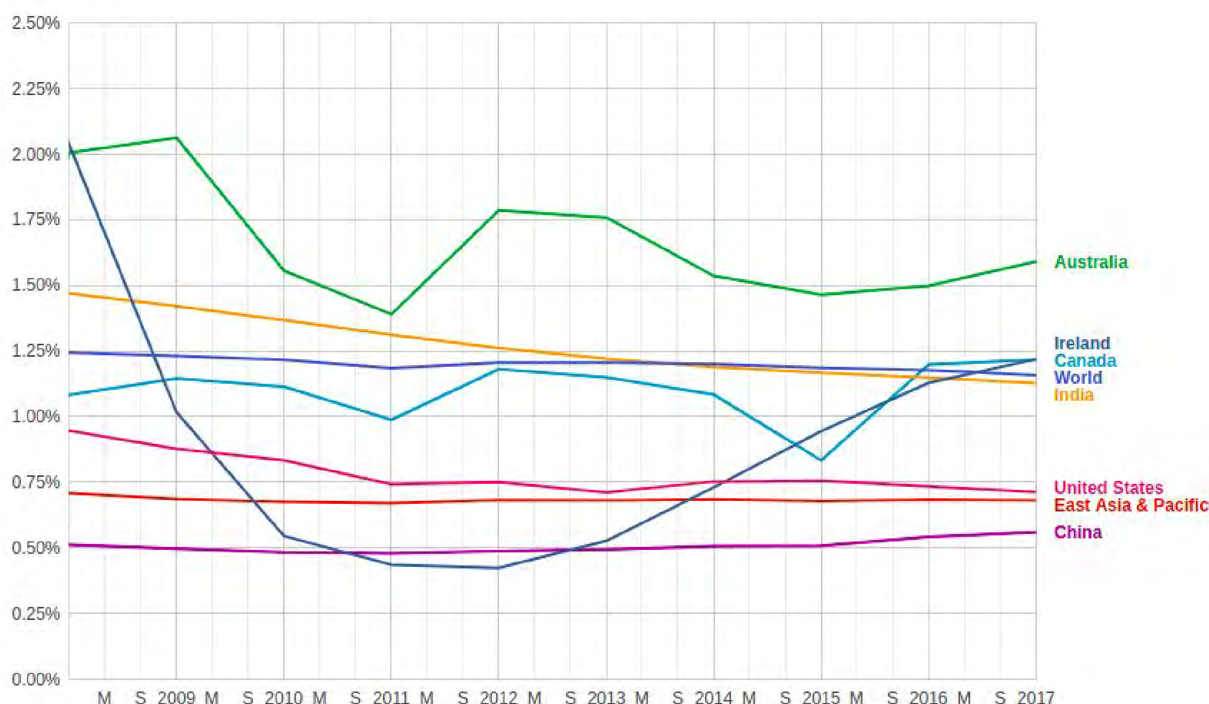

(Rodrigue, 2017)

Using the comparison of the OECD housing data the current Australian bubble could lose as much as 80% from top to bottom, meaning that the $1 million median Sydney house value might settle as low as $200,000 after reverting to mean.

# What is likely to come next? The Deflationary Trap - It's Here and It's Hiding Behind Population Growth

A deflationary trap is when people expect prices to fall and they put off purchasing which results in a fall in aggregate demand, which causes further economic contractions. A full description of this is provided by economist Paul Krugman's paper on "Deflationary Spirals" which I have included in full in Appendix A. Falling aggregate demand, lower outputs, will result in lower incomes which means ever continuing deflation. The only winners in this environment are those with **hoardings**, or those who can monopolise by being **the last man standing**. Both those with hoardings and the last man standing can present a sovereign risk if they are foreigners, or as we've seen in the last decade, entities ultimately owned and controlled by foreign states, most notably China with its mass acquisition of privatised infrastructure, agricultural land, and mining resources.

The government has largely hidden the Australian deflationary trap by importing lots and lots of people. Australia has been growing its population at an amazingly high rate. This graph from data collected from the World Bank just shows how much we've been growing our population since the GFC in 2008 compared to the world, to others in our region (East Asia and Pacific), comparable societies (Ireland which had run massive immigration prior to the collapse of its property bubble and the USA a popular destination for economic immigrants), and from the largest two sources of immigrants from which Australia is growing its population (China and India). Australia's population growth rate beats them all.




(World Bank, 2018)

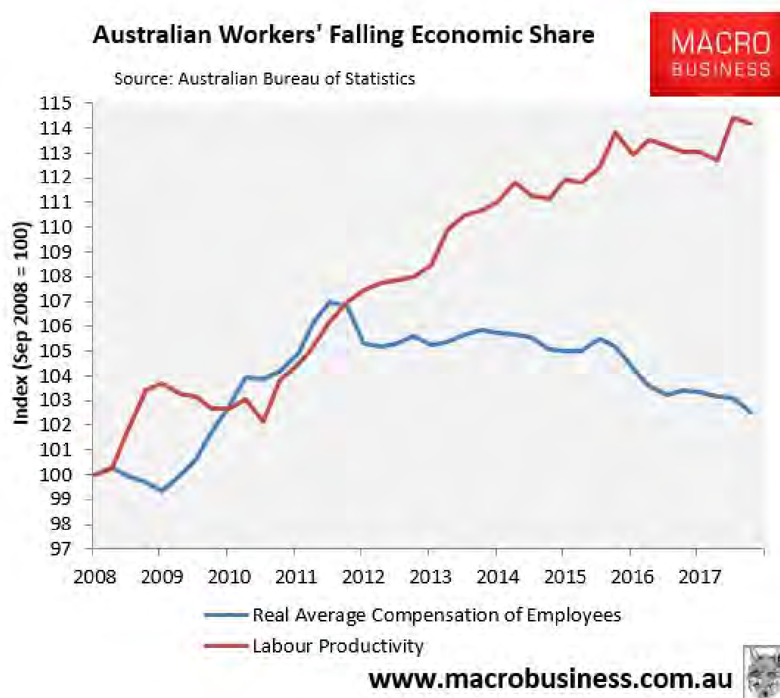
If we were to remove these imported consumers we would find ourselves without all that aggregate demand. We would be exposed to the truth of the situation, which is that we are not producing anything except more consumers. More people to demand the construction of more houses, rather

no longer houses but high density units, fuelled by the creation of more debt lent to the new arrivals, or to their landlords speculating on the property bubble, the state governments wholly dependent on Stamp Duty revenues derived from the bubble inflated prices and the privatisation of public assets, and the entire Finance, Insurance, Real Estate (FIRE) sector of the economy employing hundreds of thousands of people which rely on this unsustainable model for their own household incomes.

If this population growth was necessary because of a genuine skills shortage, we would see a rise in the cost of wages. Instead, we see that wage growth is dead. Stagnating wages combined with ever increasing rises in the cost of living creates a stress on households I have called the Personal Recession. We can see rising numbers of incidence of Personal Recessions, but because of the highly distortionary effects of rapid and massive population growth, these individual microeconomic tragedies are completely hidden by the macroeconomic headline figures of growth. Governments of recent years have lauded themselves of 27 years of continuous economic growth, but when considered as a proportion of the economic share of productivity as remuneration, and as a share of this growth per capita, the lie is laid bare.

From the economist Leith van Onselen's blog at macrobusiness (van Onselen, 2018):

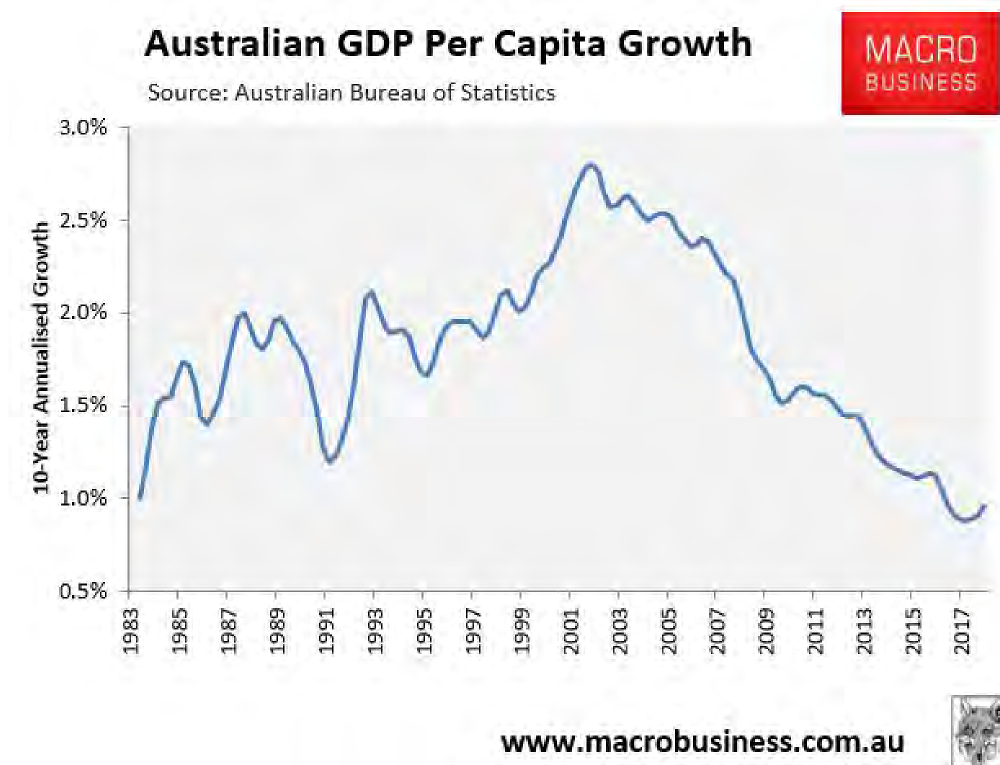
> In summary, while the headline figures are strong, there is continued weakness under the hood.
>
> First, Australian workers' incomes remain in the gutter, with the average compensation of employees continuing to fall in the year to June when adjusted for inflation.




> Second, with wages and salaries going backwards in real terms, households have been running down their savings, as evidenced by the continued expansion of household debt and the collapse in the

household savings rate to its lowest level in the post-GFC period. This is clearly an unsustainable support to household consumption, which is the main area supporting domestic demand (along with government spending).

Third, Australia's 10-year annualised growth in per capita GDP continues to track near its lowest level on record – i.e. even worse than the 1980s and early-1990s recessions:




Finally, labour productivity is weak, as evident by sluggish growth in GDP per hour worked.

So, while there is still the 'illusion' of growth at the aggregate economy level, thanks in part to force-fed mass immigration and government spending, along with debt-fueled consumption, the situation facing ordinary workers remains glum.

This is Australia's ponzi economy in action: everyone's share of the economic pie is not increasing sufficiently, wages are going backwards, and living standards in the big cities are being crush-loaded by the never ending people flood.

There has been a falling share per capita, but it is not evenly distributed. The wealth has been overwhelmingly captured by one section of society. Again, the lived experience of those born before 1965 and those born after 1980 can be demonstrated graphically. Danielle Wood and Trent Wiltshire from the Grattan Institute produced "Three charts on: the great Australian wealth gap", from 2nd October 2017 (Wood and Wiltshire, 2017):

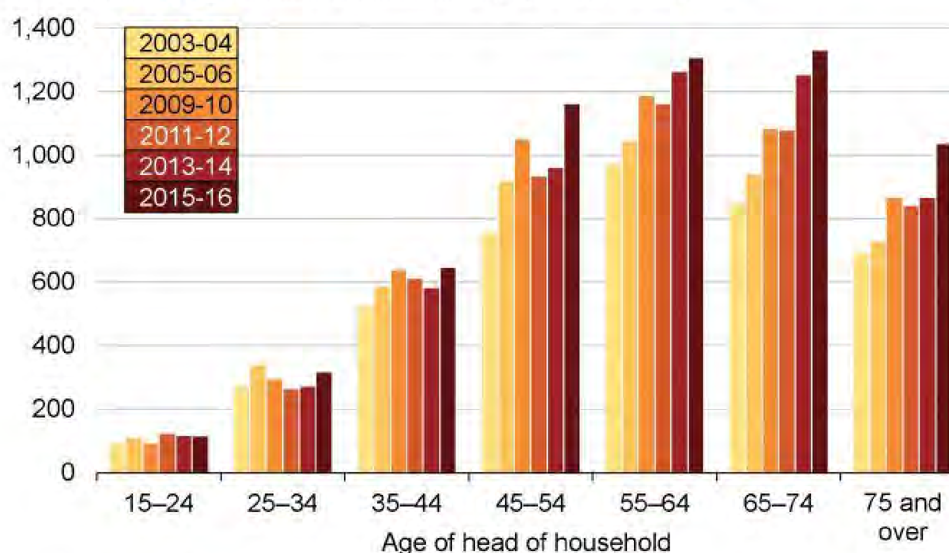
It's a tale of two Australias: older Australians are getting much wealthier, and the young are being left behind.

It's a story only too familiar to Australians under 45 who have struggled to save enough money to access the housing market in Australian cities. They are a generation for whom the great Australian dream of home ownership has become largely elusive.

Data from the Australian Bureau of Statistics (ABS) shows that older Australians are capturing an increasing share of the nation's wealth, and the house-price boom is a major cause of the growing divide between the generations.

As you can see in the following chart, households headed by 65-74-year-olds were on average A$480,000 wealthier in 2015-16 than households in the same age group 12 years ago. And that's after taking inflation into account and despite the damage caused by the global financial crisis. Households headed by 45-54-year-olds are A$400,000 richer.

In contrast, households headed by 35-44-year-olds are on average only A$120,000 wealthier – and for 25-34-year-olds the figure is just A$40,000.




Property is a key factor for wealth disparity

Soaring property prices are a major factor behind the rapidly growing wealth of older Australians. According to the ABS, house

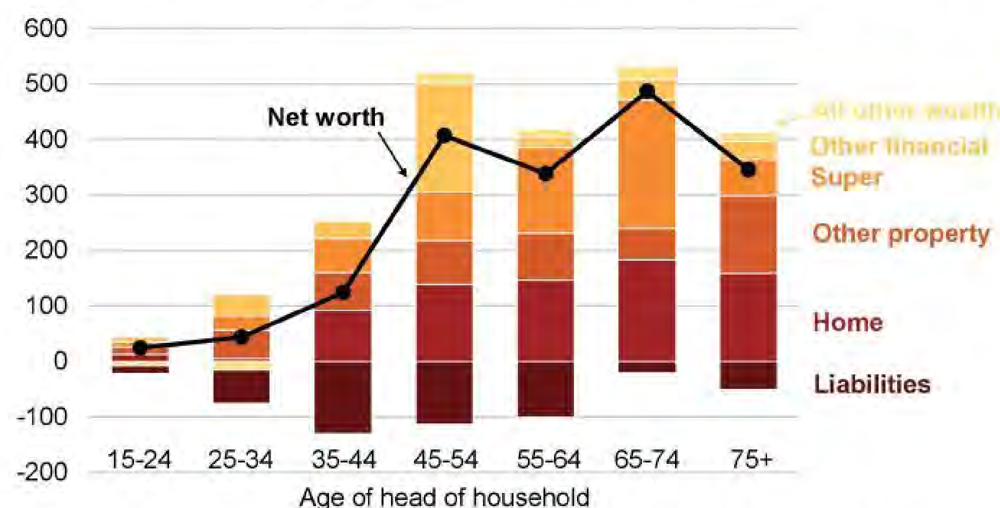
prices grew by 37% on average across all the capital cities between 2003-04 and 2015-16 (and by more than 50% in Melbourne alone). The boom was not limited to the capitals; prices also grew strongly in regional areas.

The next chart shows that for households headed by someone aged 75 or over, greater property wealth contributed about three-quarters of the increase in their total net wealth. For households headed by 65-74-year-olds and 55-64-year-olds, property contributed about half of the total increase in wealth.

But for younger Australians, again it is a different story.

Bigger mortgages largely offset the increase in property wealth for households headed by 25-34-year-olds and 35-44-year-olds. Baby Boomers have also used the superannuation system to build their wealth. They took advantage of the generous super tax breaks on offer for people nearing retirement, such as the ability to put large, concessionally taxed sums into their super funds just before retirement.

Average superannuation wealth over the same 12-year period increased by A$230,000 in real terms for households headed by 65-74-year-olds, and by more than A$150,000 for households headed by 55-64-year-olds. Strong share market returns have further boosted superannuation balances and other financial wealth.

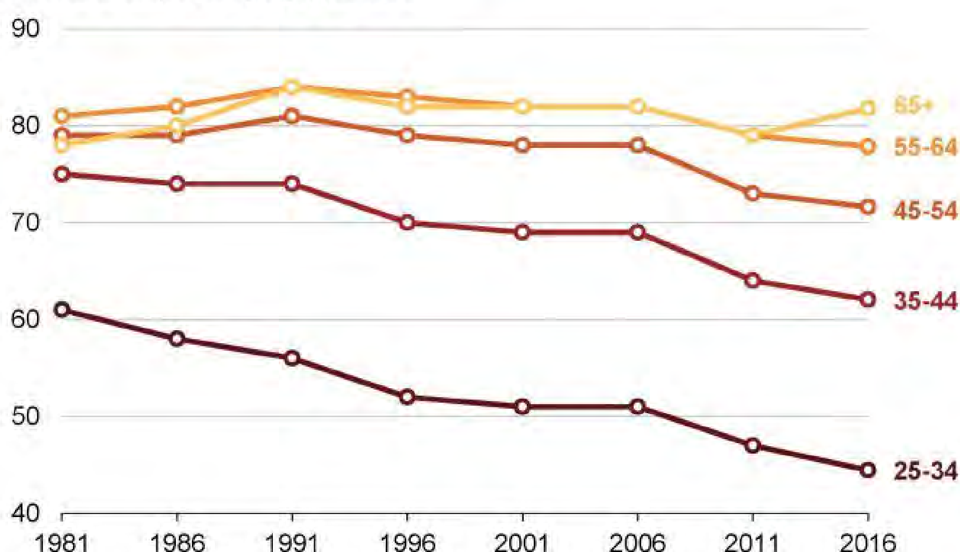


Young people locked out
As property prices have boomed, more young Australians have been locked out of home ownership.

As this last chart shows, home ownership rates among households headed by 25-34-year-olds fell between 1981 and 2016, from more than 60% to 45%. For households headed by 35-44-year-olds the fall was from 75% to around 62%. Home ownership rates are also falling for households headed by 45-54-year-olds.

Some of these falls are also partly the result of social changes: Australians are waiting until later in life before starting work, forming long-term partnerships, and having children. But most Australians still want to own a home, so it is reasonable to conclude that higher property prices are the biggest cause of lower ownership rates.

Two-thirds of 25-34-year-olds responding to a 2017 Australian National University survey thought owning a home was an important "part of the Australian way of life", and more than half were "very concerned" that younger generations won't be able to afford a house.



The bank of mum and dad
The wealth divide between generations can easily lead to a more profound divide within generations. For many younger people, the only way that they can afford to buy a house is with help from "the bank of mum and dad".

As house prices have increased, more first home buyers are receiving assistance from family and friends to enter the property market. The strong growth in the wealth of today's older generations, combined with the steady shrinking of the family size from 1960 to 2000, will lead to more and larger inheritances.

Inheritances tend to transmit wealth to children who are already well-off, and home ownership is more likely among those who receive an inheritance, and more likely still among those who receive larger inheritances.

Australia is becoming wealthier, but much of the increase is concentrated in the hands of older generations. The trend is unmistakable: unless something changes, the young will fall further behind and inequality will get worse.

This research demonstrates not only that the people born before 1965 are wealthier, but that it represents a transfer of the future wealth of young people being transferred to the old people of today. The social compact that things should get better has been discarded in exchange for things should only get better for people born before 1965 and should get progressively worse for people born afterwards.

The other thing to note is this research shows that the wealth accumulated by older Australians has largely been captured in the price of their housing. If the property bubbles collapse, and evidence indicates that it started to collapse at the start of the second half of 2017, then that wealth evaporates and all that is left behind are the huge levels of private debt.

# Australia’s Growing Subprime Lender: The Bank of Mum and Dad

As the Grattan Institute research shows a lot of young people have been locked out of progressing through the normal stages of life and those who are progressing have had assistance from the Bank of Mum and Dad, largely because of their wealth, and their access to equity in the era of “Equity, Mate!”

This creates an enormous financial risk in the economy.

The Bank of Mum and Dad is a very important player in the massive amount of fraud that is being committed when applying for loans. The commission already has an understanding of this from evidence already taken, but the evidence put before the commission so far does not present an explanation of how the Bank of Mum and Dad can create a multiplier effect on the risk.

The Bank of Mum and Dad risk multiplier goes something like this:

27-year-olds Jack and Diane want to get in on the property ladder. Property doubles in value every seven to ten years. It's all they've ever heard about their entire lives.

They both earn the median salary of $70,000 each giving them a combined household income of $140,000. They have a deposit of $50,000.

If their deposit was a limiting factor, and represented 20% of the purchase price of the house, they would be able to afford a house which costs $250,000, and would end up with a 25 year, $200,000 mortgage. Instead, they have some tricks up their sleeves.

**Trick #1 - Jack and Diane are Massive Liars**

They aren't massive liars or fraudsters ~usually~ but it's alright to commit multimillion-dollar fraud when it comes to buying a house. Everyone is doing it.

They lie about their income and include a one off bonus Diane got last month and calculated a new annual salary based on that rather than her actual wage which hasn't moved in the last two years. As the cost of living has gone up and they're squeezed by their own “Personal Recession”, especially utilities and rent, buying a house looks to be only slightly more expensive.

They lie about their existing expenses, grossly underestimating them, and don't factor in the future costs of owning a unit like strata fees, or the $30,000 special levy required to fix all of the defects that will appear over the next five years.

They lie about their savings, which brings me to Trick #2.

**Trick #2 - Enter The Bank of Mum and Dad**

That $50,000 they've saved for a deposit is actually a deposit made by their parents. With the cost of living running ridiculously high they haven't been able to save any money and they've come up with an idea to move back home. The Bank of Mum and Dad had a better idea, and set aside some money from their latest refinancing of their investment properties and deposited it in their account. Mum and Dad's refinancing actually liberated $400,000 in equity, which they're going to use to buy their next investment property, but ~helping~ Jack and Diane is such a wonderful thing to do, and reaffirms in their minds just how wonderful they are.

**Trick #3 - Jack and Diane Use a Mortgage Broker**

The Mortgage Broker has a relationship with the banks that Jack and Diane don't. They make sure that loan application is filled out just right to maximise the amount Jack and Diane can borrow. I've used Mortgage Brokers. They are amazing at what they do and are much more effective than going directly to the banks.

"Can you save more money?" the mortgage broker asks them.

Another $200,000 appears in their savings account from the Bank of Mum and Dad.

**Trick #4 - Jack and Diane’s Auction Day Antics**

Qui audet adipiscitur, Who Dares Wins, is a motto of several elite special forces units around the world. Thucydides gave us Fortune Favours the Brave. The same themes apply during an auction. I've heard people talk about their auction strategy, but let me let you in on a secret. If you pay the most money, you will win. Who Pays, Wins.

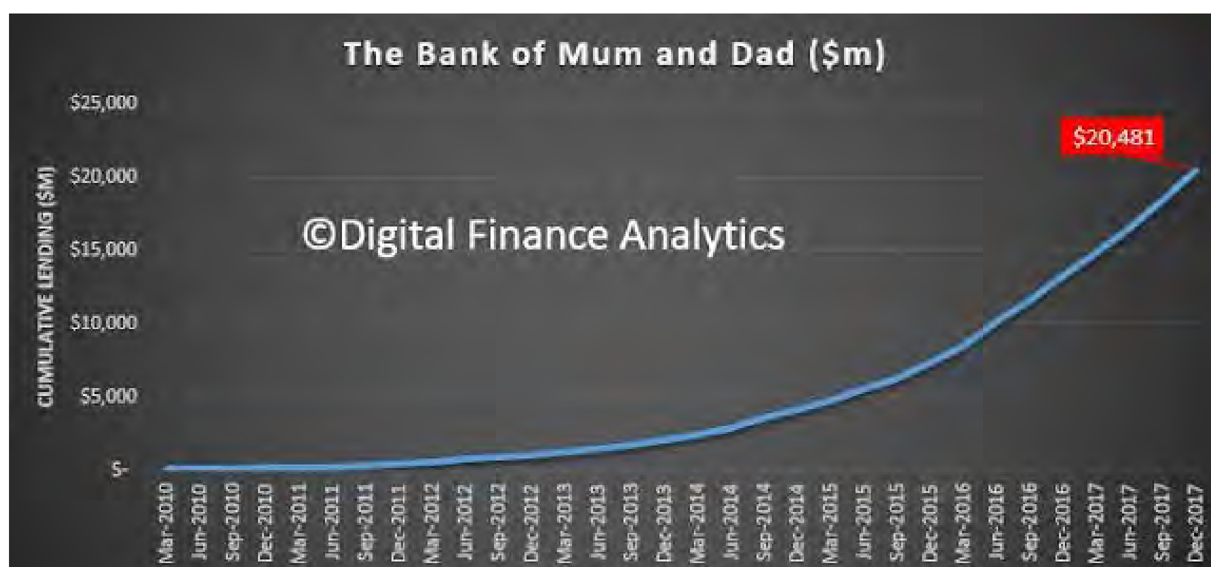
When it gets to the expensive end of the auction, when people have run out of their own finance, which is already incredibly dubious, in comes the Bank of Mum and Dad for a third time.

Jack is out of bids, and some Chinese Student Guy is winning. Jack looks to Dad, and Dad gives the nod. It's a surprise to Mum when Jack comes up with a massive $50,000 extra bid, provided of course by the Bank of Mum and Dad.

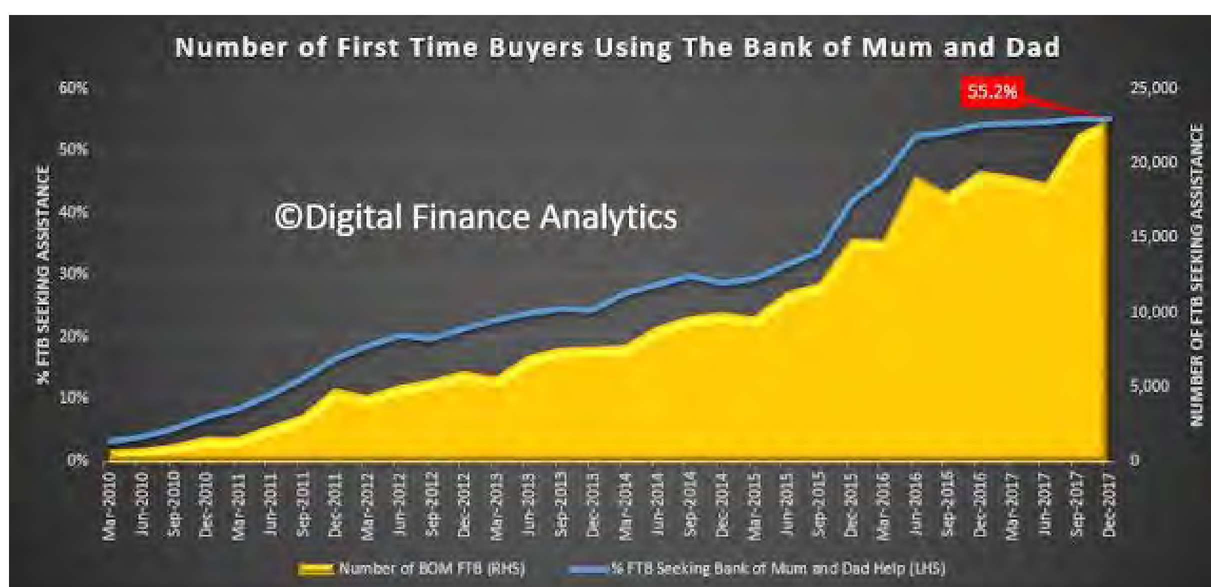
The Bank of Mum and Dad don’t necessarily have cash, they are funnelling more debt through equity. There isn’t a great pile of savings there, in fact Australians are retiring with more debt than ever before. Research referenced in an article “Rapid rise in retirees with mortgage debt” reveals the massive growth in debt being carried by people with limited earning capacity from their labour (Collett, 2018):

> In 2002 only 4 percent of homeowners aged over 65 carried mortgage debt, figures from the Australian Bureau of Statistics show. By 2015, the latest figure available, that had grown to 12 per cent.
>
> The number of 55-64 year-old homeowners with mortgage debt had more than doubled, from 23 per cent in 2002 to 47 per cent in 2015. The percentage of homeowners aged 45-54 with mortgage debt climbed from 55 per cent to 77 per cent over the same time frame.

Martin North at Digital Finance Analytics has produced analysis which shows the massive growth in this Bank of Mum and Dad debt, currently at over $20 billion, quadrupling in size over just three years (North, 2018):




And now over 55% of first home buyers utilise this risky, unofficial financial institution (North, 2018):




The unregulated Bank of Mum and Dad has become a gigantic lender, introducing significant risk into an oversupplied debt market. It is also bettings its own future into a market with significant criminal activity.

# Long Identified and Established Criminal Activity in the Property Market

In August 2015, AUSTRAC produced an analysis brief "Money laundering through real estate" (AUSTRAC, 2015):

The Money laundering through real estate strategic analysis brief is designed to provide information about money laundering methods, vulnerabilities and indicators associated with money laundering through real estate in Australia.

The key points of the analysis brief were:

- The laundering of illicit funds through real estate is an established money laundering method in Australia.
- As an established money laundering channel, criminals are likely to continue to launder money through real estate.
- Money laundering through real estate may be identified where transactions intersect with the regulated AML/CTF sector.

Earlier, in April 2015, the Financial Action Task Force (FATF), an independent inter-governmental body that develops and promotes policies to protect the global financial system against money laundering, terrorist financing and the financing of proliferation of weapons of mass destruction, identified the Australian property market and Australian financial institutions as a significant risk in their report “Anti-money laundering and counter-terrorist financing measures, Australia, Mutual Evaluation Report”

Among the key findings were (FATF, 2015):

- Most laundering involves use of the banking sector, money remitters, and complex corporate structures, facilitated by gatekeepers. Australia is seen as an attractive destination for foreign proceeds, particularly corruption-related proceeds flowing into real estate, from the Asia-Pacific region. Outwards proceeds flows are directed mainly to major financial hubs in Asia and the Middle East, with tax proceeds also flowing to European havens.
- Australia remains at significant risk of an inflow of illicit funds from persons in foreign countries who find Australia a suitable place to hold and invest funds, including in real estate.
- Most DNFBPs, including real estate agents and legal professionals, are also not subject to AML/CTF controls or suspicious transaction reporting obligations, even though they are highlighted as being high-risk for ML activities.
- China; Hong Kong, China; Macau, China; Singapore and the United Arab Emirates were seen as major source, destination, and/or transit jurisdictions for proceeds of crime laundered into and out of Australia. Large amounts are suspected to be laundered out of China into the Australian real estate market. China and other countries within the Asia-Pacific region were also seen as likely sources of corruption proceeds that are laundered in Australia.

- Professional facilitators (lawyers, accountants, TCSPs – especially from lower tier firms) were almost universally understood as a major ML risk - but the authorities have not addressed that risk by including them within the scope of the AML regime. Obligations to record details about beneficial ownership of customers, companies, and trusts by professional facilitators as well as report suspicions to AUSTRAC may enhance detection of ML/TF activity as well as facilitate the timely tracing of criminal assets. This is particularly relevant for the latter where the authorities indicated that tracing proceeds is often frustrated through the use of complex corporate structures.
- The authorities could also do more to proactively address the ML risk from foreign proceeds, including by regulating real estate agents, one of the DNFBPs most exposed to the activity, and by law enforcement more actively pursuing foreign predicates crime. The laundering of foreign proceeds of crime in Australia (particularly in the real estate sector) was acknowledged by some of the authorities and much of the private sector as a high ML risk, but assessors' attention was not drawn to any national policies explicitly targeting or prioritising this risk. Of great concern is that Australia has not brought real estate agents within the AML/CTF regime.
- Ensure that lawyers, accountants, real estate agents, precious stones dealers, and trust and company service providers understand their ML/TF risks, and are required to effectively implement AML/CTF obligations and risk mitigating measures in line with the FATF Standards. Ensure that reporting entities implement as early as possible the obligations on enhanced customer due diligence (CDD), beneficial owners, and politically exposed persons introduced on 1 June 2014.

On the 29th March 2017 Transparency International released its report "DOORS WIDE OPEN: CORRUPTION AND REAL ESTATE IN FOUR KEY MARKETS" The report notes (Transparency International, 2017):

> Australia has severe deficiencies under all 10 areas identified in the research and is therefore not in line with any of the commitments to tackle corruption and money laundering in real estate made in international forums.
>
> In Australia, real estate agents are not subject to the provisions of the Anti-Money Laundering and Counter Terrorism Financing Act 2006. Other professionals such as lawyers and accountants who may also play a role in the sector are not covered either. This means that properties can be bought and sold without any due diligence on the parties. Currently there are no requirements for real estate agents or any professional involved in real estate deals to submit STRs, even if they suspect illegal activity is taking place, and there are no requirements or rules for verifying whether customers are PEPs or their close associates.
>
> Of the countries analysed, only Australia has a check on foreigners wishing to purchase residential properties, but there is no requirement to disclose the identity of individuals (or beneficial owners) behind foreign companies purchasing property.

On the 11th of April 2018 the ABC reported AUSTRAC was given authority to scrutinise Cryptocurrency under newly introduced anti-money laundering and terrorism funding laws (Letts, 2018) **yet the long known money laundering path of the property bubble remained totally unsupervised and not policed**. The implicit result is that it is OK to launder money through the property bubbles, but nowhere else.

It is in this murky world of international money laundering that ordinary Australians compete with foreign criminals in the purchase of residential property.

# Recommendations

## What to do about deflating the bubbles?

- Remove stamp duty. This is creating friction preventing people from downsizing and is the single biggest inhibitor to upfront affordability.
- Remove the tax concessions such as the capital gains tax exemption on the primary place of residence.
- Isolate the deductibility of costs of asset holding to the income earned by that asset, essentially gaoling negative gearing to the costs of the property income generated by the property.
- Stabilise population growth to sustainable levels.
- Stop the transfer of public money to home buyers. There is no relationship to these payments, which are at their highest levels ever, and first homebuyer home ownership, which is at its lowest levels ever.
- Put a minimum loan to value ratio on the amount Self Managed Superannuation Funds can borrow to purchase residential housing.
- Ban the ownership of residential property by all foreigners.
- Investigate the ultimate ownership of companies purchasing residential property, and all owners of the company must be resident, Australian citizens.

## What to do about bank stability and regulation?

- Improve transparency. All politicians and public servants and their immediate family members must disclose their assets in a public register. The RBA and APRA have blown massive property bubbles and it is likely many in these institutions stand to personally gain great fortunes from these bubbles.
- Revoke the $50 and $100 notes as being currency. These notes can be deposited into two new public banks, the Public Bank, a transactional bank operated by the central bank which accrues the payments of the Citizens' Dividend/Universal Basic Income, and the Rural Bank, a bank of foreign exchange and foreign currency holding operated by the central bank, which must be used to finance all purchases of non-residential property and foreign direct investment by foreign entities.
- Remove the distortionary government guarantee on deposits for private banks, and only maintain for the Public Bank. This removes the risk of guaranteed deposits being used to recapitalise a failed bank.

- Limit Interest Only loans to a period of one year, and only once per property to remove the refinancing problem.
- Verify incomes and expenses of people to prevent fraudulent loan applications.
- The Bank of Mum and Dad needs to be regulated like normal banks are regulated.

## What to do about the failure of monetary policy?

- Zero Interest Rate Policy has only delivered a gargantuan property bubble and punished our exporters. We need to decouple the interest rates from external and domestic policy interests.
- The marginal propensity to consume is a much more real and easy to manage thing, in that it can be pushed and pulled, while interest rates can only be cut (the pulling on a string) in the hope they stimulate borrowing until they don't in which case it becomes pushing on a string. The economy is better served by stimulating and stymying consumption through the variance on the rate of consumption taxes. Indicating the GST will increase will trigger rapid spending and injection into the economy, and a low rate of GST will maintain an elevated amount. A high GST will put a handbrake on spending as will the promise of a cut in the future.

## What to do about predatory lending?

- The establishment of a special Mortgage Discharge Tribunal where if fraud has been conducted by the banks or their agents, the mortgage can be discharged.

## What to do about the financial illiteracy of Australians?

- Introduce critical thinking and risk comprehension education throughout K-12 education
- Compulsory financial literacy education and certification for all Australians who want to purchase debt. Yes, people should have a license to use a credit card.

## What to do about the Deflationary Trap?

- Stop the speculation into real estate. Remove all the supports of the contributing factors to each of the three property bubbles.
- More Tax reform. Move away from income taxes, which are inefficient and avoidable, and move exclusively to Land tax (tax that which cannot be hidden) and Consumption tax (tax that which cannot be avoided). This will free up significant amounts of money that could be better used as discretionary spending, or servicing the debts incurred by those who speculated on the property bubble.
- Introduce a Citizen’s Dividend, a Universal Basic Income to replace politicised malinvestment in public spending. This will avoid political pork barrelling, introduce inflation, and address the lowest savings ratio in our nation’s history. The property bubble speculators can use their UBI to pay their loans, while those who didn’t binge on debt can spend theirs as they see fit.
- Universal Basic Income will provide economy wide, nation wide stimulus
- Limit the Universal Basic Income to native born Australians to prevent the pull factor of free money. Too many people coming too quickly has caused significant problems. The native citizenry have a special place in our society.

- Introduce a 50% premium on wages for imported skilled workers to prevent the use of scab labour, and have these workers paid from a government run Foreign Workers Payroll which the employers pay into to prevent the use of slave labour.
- Conduct a plebiscite on whether Australia should commit to a Big Australia or a Sustainable Australia to get the population growth problem under control.

## What to do about criminal activity in the property market?

- Implement the recommendations of FATF, Transparency International, AUSTRAC so that Money Laundering and Counter Terrorism financing laws are universal across all sectors of the economy.
- Conduct an exhaustive analysis of all property transaction through the various title offices for the past twenty years, and make appropriate seizures of assets and prosecutions of criminals.
- Increase the standards of character for facilitators of property transactions

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# Appendix A - The Deflationary Trap Explained By Paul Krugman

Economist Paul Krugman describes the deflationary trap well enough in “Deflationary spirals” (Krugman, 1999):

Among the growing number of observers who now regard deflation as a serious risk for the world's major economies, there is a subtle difference of opinion about the sources of that danger. One view - which is the one that I have espoused for Japan, and set out most recently in my piece Can deflation be prevented? , is that deflationary pressures are essentially structural: the economy's equilibrium real interest rate is negative, and so even with a near-zero nominal interest rate it remains underemployed and generates gradual deflation unless policymakers somehow manage to create expectations of enough inflation to get the real interest rate down where it belongs.

The other view is that while deflation can be a real danger, that danger arises less because of an inherent deflationary bias than as the potential consequence of policy mistakes; the general idea is that once mistaken policies have allowed deflation to get started, expectations of continuing deflation can be self-reinforcing. And once the economy is in such a deflationary "death spiral", the story goes, it can be very hard to get it out again.

These views are not mutually exclusive: one can believe that there are structural forces that give an economy a choice between adequate inflation and grinding deflation - with no middle ground - and also believe that waiting too long to face up to that choice can lead to a downward spiral. But the logic of deflationary spirals implies that even an economy whose equilibrium real interest rate is positive can get into a deflationary trap if its central bankers are too cautious, too preoccupied with fighting the last war. By the time they realize that the nature of the danger has changed, it can be too late. (Any resemblance to current debates about European policy is completely intentional).

In this note I take a standard macroeconomic model, slightly modified by introducing a floor of zero on the nominal interest rate - that is, by introducing the possibility of a liquidity trap - and show that it quite naturally generates both the possibility of a deflationary death spiral and the implication that central bankers may have a window of opportunity in preventing such a spiral that, once missed, is gone for good.

The standard model

Consider a simple, rather old-fashioned IS-LM-type model of an economy in which expectations of inflation are adaptive rather than "rational" - that is, in which people form views about future inflation based on past experience rather than based on considerations of future government policies and so on. I assume that the expected inflation rate that enters into the wage-price process is the same as the expected rate that affects spending decisions; the result is a model similar to that used in standard macroeconomics texts like Dornbusch/Fischer or Gordon. The model considers only a closed economy; as argued in Japan: still trapped an open-economy version would behave in a qualitatively similar way.

For convenience, the model is log-linearized. First, the deviation of real output from its "natural" level depends on the real interest rate:

$$(1)\ y = a - b(i - n)$$

where i is the nominal interest rate, and n the expected rate of inflation.

Next, the demand for real balances depends on income and the nominal interest rate:

$$(2)\ m - p = c + dy - ei$$

The rate of inflation is determined via an expectations-augmented Phillips curve:

$$(3)\ dp/dt = hy + n$$

with expectations of inflation adjusting gradually in response to actual inflation:

$$(4)\ dn/dt = k(dp/dt - n)$$

Finally, monetary policy consists of assigning a constant growth rate to the money supply:

$$(5)\ dm/dt = g$$

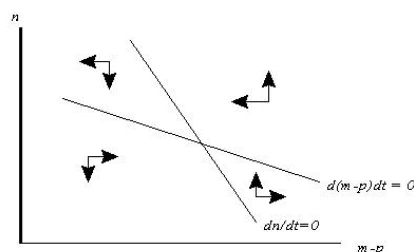


**Figure 1.**

To analyze this model, it is easiest to think of dynamics in the space illustrated in Figure 1 . On the horizontal axis is the real money stock, m-p. On the vertical axis is the expected rate of inflation, n.

Two schedules are shown. One is the locus of points along which y = 0, that is, output is at its natural level, and hence (from (3)) at which the expected rate of inflation does not change. Because expected inflation reduces the real interest rate, and hence expands the economy other things equal, this schedule is downward sloping. The other is the locus of points along which actual inflation equals the rate of money growth, so that the real quantity of money does not change. Since higher expected inflation means higher actual inflation, and so does a larger real money supply, this schedule is also downward-sloping. It is straightforward to show, however, that the second schedule is flatter than the first.

The arrows indicate the dynamics of the system. The system is not self-evidently stable, but if expectations do not adjust too quickly it will be.

The conventional exercise in this model is to consider the effects of a change - say, an increase - in the rate of money growth. Such an increase shifts the schedule d(m-p)/dt = 0 up, and thus leads in the long run to a higher expected inflation rate and smaller real money supply; however, on the way the economy will experience a temporary increase in output followed by a period of "stagflation" as output falls and inflation rises. All this is standard stuff, the staple of intermediate textbooks.

But now let us modify the model slightly, by recognizing that the nominal interest rate cannot be negative, and hence that the money demand function (2) must become perfectly elastic at a zero interest rate.

Adding the liquidity trap

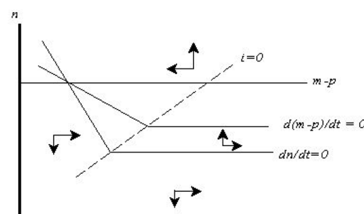


**Figure 2.**

Figure 2 shows what happens to the dynamics when a zero lower bound on the interest rate is introduced. The interest rate itself, of course, depends on the expected rate of inflation and the real money supply - positively on the first, negatively on the second. So we can draw a line (the dotted line in the figure) along which i =0.

When the schedules of Figure 1 cross this line, they make a sharp left turn. That is, the real money supply becomes irrelevant at the margin, and so the schedules become flat, with output and inflation depending only on the expected inflation rate.

I have drawn this figure for the case of a zero rate of increase in the money supply, so that the equilibrium rate of inflation is zero, and have also drawn it so that the zero constraint will not bind at that rate - that is, the equilibrium real interest rate is positive. Nonetheless, the economy can still get into a liquidity trap if people expect sufficiently rapid deflation.

What is immediately apparent is that if the economy gets into the southeastern region of the diagram - below the line y = 0, so that the economy has excess capacity, and also below the line i = 0, so that it is in a liquidity trap - it cannot get out. The output gap feeds expectations of deflation, and since the nominal interest rate cannot fall this implies a rising real interest rate, worsening the output gap. The economy, in short, falls into a deflationary spiral.

And once the economy is in such a spiral, accelerating the rate of monetary growth will (if we take the model literally) do nothing to stop it.

We may believe that in practice there may be some natural limits to this process: even in the 1930s the economy eventually found a bottom. But the picture is simple and plausible enough to make concerns about such a "death spiral" entirely reasonable.

A window of opportunity?

Imagine an economy with "incipient" deflation - that is, prices are either rising slightly or falling slightly, but there is a substantial output gap; so far, however, deflation has not yet gotten built into expectations, and the nominal interest rate is still positive. One might intuitively suspect that in this case there is a window of opportunity for the central bank: if it launches a vigorous monetary expansion immediately, it can still steer the economy away from the deflationary spiral, but if it misses this window, deflation may pass the point of no return.

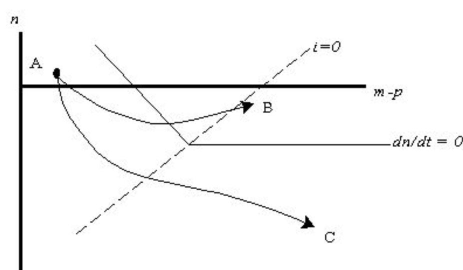


**Figure 3.**

This intuition is confirmed by the model. Consider Figure 3 , in which only the schedules dπ/dt = 0 and i = 0 are shown. The economy is assumed to be initially at point A. Where it goes depends crucially on the near-term rate of money growth. If money growth is rapid, it follows a path like B, avoiding the liquidity trap; but if the central bank is cautious, and waits to see definite evidence of deflation before acting, it will instead follow a path like C, so that by the time the need for a more expansionary policy is unmistakable it is also too late.

This is, of course, only a simple and highly stylized model. But the resemblance to reality is strong enough to be worrisome; conservative monetary policy may seem prudent and responsible to the European Central Bank today, just as it did to the Bank of Japan not long ago, but in retrospect that supposed prudence may look like disastrous folly.