THE AUSTRALIAN

The Productivity Commission gets it wrong on Economics 101

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The god of long reports makes sure no one reads them. Having released its 600-page draft report on competition in the Australian financial system, the Productivity Commission would do well to keep the candles at that god's shrine burning.

That is not to ignore the report's virtues. It is at times informative, and some of its recommendations are eminently sensible. But its reasoning is littered with glaring errors and often misses the point.

It is, for example, astounding to be told that "costs can only be persistently passed on in sectors such as banking, where pricing power exists". What, the reader might wonder, happens to them elsewhere?

But the statement is not merely absurd: even applied solely to cost increases, it is exactly wrong. Those increases, as first-year - economics students learn, are fully passed on in perfectly competitive markets, but not in markets where market power has already lifted prices above competitive levels.

It is every bit as astonishing to read, in the report's discussion of lenders' mortgage insurance (which lenders purchase from specialist insurers and then provide to borrowers), that "since providers usually pass on the cost of LMI to consumers, there is no strong incentive to make sure the price is competitive".

Again, the statement is exactly wrong: a monopolist over hammer heads, who also provides consumers with hammer handles she buys from third parties, has every incentive to beat down the price of hammer handles, as that allows her to take a larger share of the overall willingness to pay for hammers. And since she can claim all the greater take for herself, her incentive is more powerful when she has monopoly power than when she doesn't.

On top of sloppiness, there are the straight-out errors of fact, some of them crucial.

The report claims, for example, that "history shows that a government cannot credibly assert that a large institution will be allowed to fail".

Yet history shows no such thing. Not only is there a long record of major financial institutions being placed in bankruptcy, but wiping out shareholders' equity and then winding up or nationalising insolvent institutions was at the heart of the strategy the Nordic governments adopted for dealing with a devastating financial crisis in the early 1990s — a strategy widely regarded as defining international best practice.

Moreover, even at the height of the global financial crisis, very substantial banks, such as Washington Mutual, were placed in bankruptcy by the US Federal Deposit Insurance Corporation, which regulates institutions that hold government-insured deposits. Even more importantly, prudential regulators worldwide are implementing an ambitious program aimed precisely at ensuring that no matter how large they are, institutions can, if necessary, be wound up in an orderly manner, without imposing substantial costs on smaller depositors, taxpayers or financial stability.

Completing those efforts, which the PC largely ignores, would be one of the most effective ways of both eliminating the belief that major institutions will be bailed out and allowing potentially anti-competitive banking regulations to be scaled back.

Those lapses might be forgiven had the report approached its central task of assessing the competitiveness of the financial system objectively.

However, the report's method is simplicity itself: having presumed that the system is not competitive, it dismisses any evidence that contradicts its claim.

A market structure similar to that in comparably-sized economies? Costs that seem low by international standards? Falling profit rates? Pervasive discounting? Greater convenience and product variety? Despite troubling instances of misconduct, high levels of consumer satisfaction with their own bank?

Each pooh-poohed, frequently through contortions that strain belief, as when we are told on one page that outcomes in a competitive market would "tend to converge to a mean" and on another that "in a competitive market, significant diversion from that mean might have been expected". Adding to the concerns, while the report claims to test whether the market is "workably competitive", the indicators it dismisses are the very ones economists John Maurice Clark and Jesse Markham identified as compelling evidence of workable competition in introducing the term and pioneering its application.

The lack of rigour carries over to the report's policy analysis. Its assessment of the Australian Prudential Regulation Authority's intervention to limit loans to real estate investors is a case in point. That assessment leaves the critic as overwhelmed with choice as a mosquito in a nudist colony.

But to take one issue alone, the report repeatedly complains that the banks, in reacting to the intervention, raised interest rates on both new and outstanding investor loans.

However, it is surely obvious that when the total quantity of a good that can be sold is rationed, the opportunity cost of an ongoing sale is a new sale. Efficiency therefore requires that their prices be equalised, so that scarce loanable funds are used by those who value them most highly.

Nor is that equalisation in any sense unfair: after all, the investors whose rate increased had chosen variable rate loans.

In the old days, the Productivity Commission would have compared the actual outcome to that which would have prevailed had APRA auctioned permits to make investor loans; clearly, rates on both new and ongoing loans would rise above the unrestricted level.

The risk is that the report's many errors will fuel the jihad against the banks. But they also pose a fundamental question: what has happened to the commission?

It, too, must be accountable, and taxpayers have every right to demand that the government launch a serious review of its -operation.

More than ever, Australia needs what once was the commission's hallmark: consistently credible, rigorous and independent policy analysis.

If there is a lesson from this report, it is that we no longer have it.