

= SUBMISSION =

FINANCIAL SYSTEM INQUIRY
GPO Box 89
Sydney NSW 2001

FINANCIAL SYSTEM INQUIRY

Robert H Butler
Solicitor,
27 Devilliers Avenue,
CHATSWOOD NSW 2067

SUBMISSION

Robert H Butler

FINANCIAL SYSTEM INQUIRY

Pending the Inquiry's Interim Report indicating the approach being taken by the Inquiry to its Terms of Reference I have not made a previous Submission.

The Interim Report makes clear the axiomatic approach which the Committee is taking in dealing with the tasks assigned to it by its Terms of Reference. That approach has no doubt been influenced by the banking backgrounds of Committee members. Indeed, one could be forgiven for agreeing with John Dahlsen, former ANZ Director and member of its audit committee that "*The interim report has been prepared by bankers, on behalf of bankers, for bankers*" and as nothing more than a superficial attempt to defend the status quo of bank power.

The Interim Report re-affirms that axiomatically the Committee advocates measures which attempt to justify the preservation of and support for the monetarist system which is the very cause of the recent existential threats to the financial system and the cause of the events which have resulted in the appointment of the Inquiry.

We have to firstly have an understanding of what an economy is. In brief, there are two aspects to any modern economy. One aspect is the monetary aspect: the use of money as a medium of exchange. The second aspect, is the physical economy. A monetarist system focuses only on the first aspect and is based on the assumption that there is a lawful relationship, or a statistically lawful relationship, between the circulation of money, and economy. And that is not true. We must define economy, not in Cartesian terms, or mechanistic terms, or conventional empiricist terms: we must define economy in terms of a physical economy which is not simply an equilibrium of the relationship among the physical components of economy, including human labour and human existence. To achieve a profit in a physical economy, the profit can not exceed the rate of physical growth - the rate of increase of productivity, per capita and per square kilometre. The only sustainable basis for such an increase in per-capita output and standard of living, to compensate for attrition - that is, the depletion of resources - is scientific creativity, the discovery of scientific principles and their application in new physical technologies.

The Interim Report makes no reference to a physical economy and specifically notes that despite the fact that...

"This Inquiry's objective is to assess, and make recommendations on, how the financial system can most effectively help the Australian economy be productive, grow and meet the financial needs of Australians"

it is approaching its tasks from a purely monetarist point of view without reference to a physical economy or any consideration of what an "economy" really comprises:

"To meet this objective, the Inquiry considers that the financial system must satisfy three principles: efficiently allocate resources and risks, be stable and reliable, and be fair and accessible. These three principles underpin the following analysis."

Views expressed by Committee members at public forum hearing have also confirmed the axiomatic approach of the Committee - that Australia is dependent upon foreign capital and therefore needs to conform to international dictates, that a Glass-Steagall approach can be adequately dealt with by "ring fencing" (if undertaken at all), that National Banking is an 'untried, go-it-alone' approach, that a systemic threat to the banking system can be dealt with by "bail-in" and that over-all the most important consideration is the preservation of the banking system as presently structured, even at the expense of people. No consideration is given to the fundamental purpose of a banking system or the extent to which that has been lost sight of in the sequence of steps which have been taken in the last four decades to bring about the current threats to the system.

There is no natural cause for the recent Global Financial Crisis or our economic decline. Bad policy, not nature, is the culprit. The presently ongoing collapse has been brought about through more than a quarter-century of wrong-headed choices of economic policy and science policy generally, wrong policies of virtually every government and other relevant institutions. The proximate cause for this collapse of leading political, and other public and private institutions, is rooted in radical monetarist policies and ideology exemplified by the runaway metastatic cancer known as "the derivative bubble." This monetarist bubble, whose growth and revenues of "risk management," are praised as the proof of "economic recovery," has been represented as a praise-worthy substitute for all forms of physically productive employment, for increase of per-capita levels of combined producers' and households' market-baskets, and has been adopted as a substitute for disastrously collapsing levels of basic economic infrastructure, of agriculture, and of industry, in Australia and world-wide. Such toleration of that metastatically ballooning cancerous bubble, and the wilful murdering of the real economy in the name of monetarist speculation, is the cause of our current economic plight. As long as we refuse to overturn those axiomatic policy-assumptions associated with monetarist dogmas of "free trade," "privatisation," "deregulation," "central banking" (as opposed to National Banking), and anti-scientific, "neo-malthusian," "post-industrialist" utopianism, there is no policy, no law, no budget which could be enacted by government without far more disastrous consequences than the circumstances would be without such "reforms." Until government is willing and able to take "dirigistic" forms of programmatic economic action which violate directly, and fundamentally the mythologies of "I.M.F. conditionalities," "neo-Malthusianism," "post-industrialism," and "free trade," we will go from bad to worse, in rapid succession.

I accordingly wish to address some of the fundamental issues which should be at the very heart of the Inquiry and which are required by the Terms of Reference which do not justify or authorise the limited axiomatic approach which is indicated by the Interim Report.

The Terms of Reference require the Committee to "*refresh the philosophy, principles and objectives underpinning the development of a well-functioning financial system*". That raises the fundamental issue of the very purpose of a "financial system".

There can be no issue as to the fact that a properly functioning banking system is necessary for any modern developed society. Historically, the issue with banking has been its position and function within society - should it be an instrument of society to be regulated and controlled by society (by way of its elected representatives) so as to assist in undertaking those activities beneficial to society or should it be permitted to become a power in itself which can control and dictate to society and government.

Sections 51 (xii) and (xiii) of the Australian Constitution vests in the Commonwealth Parliament jurisdiction over currency and banking. The Commonwealth Parliament has power with respect to:-

- S51 (xii) - "*Currency, coinage, and legal tender*"
- S51 (xiii) - "*Banking, other than State banking; also State banking extending beyond the limits of the State concerned, the incorporation of banks, and the issue of paper money*".

Since the splitting-up of the functions of the Commonwealth Bank and its privatisation, Australia has effectively delegated these banking and credit creation powers into the hands of private banks in a deregulated system.

The twentieth century in Australia saw the position and power of banks come to the fore as an issue on a number of occasions. From the time of Federation, attempts were made, particularly through the efforts of King O'Malley MLA, to create a National Bank to provide Australia with a sovereign money system to fund Australia's development and remove the controls exercised by the banking system, particularly those based in the City of London. Though limited in functions when actually created, the Commonwealth Bank provided great financial and physical benefits to Australia during and immediately after WWI and showed what is possible with a National Bank. It enabled Australia to finance its pressing needs without any foreign investment.

1920's legislation placed the Bank under the control of the private banks and, under that control, its refusal to grant credit to Government during the Depression of the 1930's deepening the misery of that period, with the Conservative Senate rejecting legislation which would have created that necessary credit in the form of "fiduciary notes".

This attitude and approach to the 1930's financial crisis should be compared with the diametrically-opposed policy adopted by the Roosevelt Administration in the United States. In the period 1933-45, President Franklin Delano Roosevelt transformed an American economy that was collapsed by depression, and whose banking system had fissured apart, leading it through a successful economic recovery. Roosevelt made a fundamental change by sweeping away the method of the British System of economy, which had dominated earlier Twentieth-Century America, and caused the Depression. He replaced it with a return to what the first U.S. Secretary of the Treasury, Alexander Hamilton, had described as the American System of political economy (and by List as the National System of Political Economy), with its commitment to nation-building and economic development. As Hamilton had described it, the American System represents the commitment of the nation to the principle of promoting the General Welfare, through priority on the cognitive development of the citizen. This meant, then as now, the capital-intensive, power-intensive development of the physical economy, inclusive of infrastructure, to produce growth. The sovereign powers of the nation-state must be aroused, to promote scientific progress, and to create the advancement of mankind.

Roosevelt instituted his American System recovery in two phases. First, through the New Deal of the years 1933-37, Roosevelt revived the existing manufacturing and agricultural capability, which had been closed by the Depression. He also built a magnificent array of technology-transmitting infrastructure. Later, during the economic mobilization for World War II, which was conducted from 1939-44, Roosevelt introduced a qualitative change. He made scientific discovery - and the machine-tool design principle - the driver for the economy. The latter mobilization injected a scientific-technological revolution into every aspect of the economy, and built a new layer of manufacturing and productive capacity, of the highest technological level. This was in addition to the capacity that had existed prior to the war. The end result was a revolutionary reordering of the U.S. economy for a vastly increased technological level of development. This combination of measures, not only defeated the Depression, but generated explosive, anti-entropic growth.

In this American System, as Hamilton named it, the nation-state acts for the interest of the entire population, present and future. The state positively intervenes to shape the economy: it directs cheap and abundant credit to foster capital-intensive, power-intensive manufacturing, agriculture, and infrastructure; it fosters scientific discovery and the incorporation of advanced discoveries into the machine-tool design sector; it develops the cognitive power of the labour force; it regulates its economic and financial affairs, and crushes speculation. As a result, there is an increase of the rate of potential relative population density, the measure of a successful culture.

Under what came to be known as his New Deal, Roosevelt applied the American System by aid of such measures as the following:

- He stabilized the banking system;
- He directed cheap and abundant credit into the economy, using such agencies as the Reconstruction Finance Corporation (RFC), and other government agencies which he created. This was the equivalent of a National Bank.
- He built magnificent infrastructure, with the Tennessee Valley Authority (TVA) in the forefront. The Tennessee Valley encompasses a watershed of tens of thousands of square miles spanning seven states. The TVA built an integrated development project, which developed abundant hydroelectric power, accomplished flood control and river diversion, provided scientific agriculture and new industry, eradicated malaria, and spread education to overcome illiteracy. It re-shaped a region in a revolutionary way, and became a model for the world, including our own Snowy Mountains Scheme. Roosevelt's New Deal also built the Rural Electrification Administration, and constructed tens of thousands of sanitation projects, hospitals, schools, ports, and public buildings. Roosevelt launched public works programs which employed millions of workers building the infrastructure.

The New Deal also famously introduced social programs of justice, like Social Security for the aged and disabled; employment insurance for the unemployed; the right to organize for labour, etc. President Roosevelt operated on the concerns of the downtrodden. He introduced legislation, such as the Glass-Steagall Act, that went after Wall Street looting and corruption. The New Deal stopped the farm and home foreclosures, stopped the loss of savings accounts, restored whole sections of the economy and nation, and prevented the disintegration of the republic. The success of the New Deal was completed by the economic mobilization for World War II, which had a different emphasis, but was based on its method.

There have been calls in Australia for a new Pecora Commission to investigate the financial industry. The original American Pecora Commission, an investigation into the financial machinations which led to the Great Depression, conducted by the Senate Banking and Currency Committee from 1932 to 1934, exposed the way in which a cabal of powerful bankers dominated the U.S. economy, and manipulated it to suit their own goals. The investigation was run by Ferdinand Pecora, a former prosecutor who hauled some of the most prominent bankers in the nation before the committee and revealed them to be, under their pompous, self-righteous veneer, a pack of self-serving, arrogant, and corrupt hyenas who had little regard for the interests of the nation and its people. In doing so, Pecora smashed the myth of public service the bankers and their publicists had so carefully crafted, and helped build the public support President Franklin Roosevelt required to force Congress to pass tough regulatory reforms.

The situation today is even worse than the one faced by FDR. Then, the U.S. still had a strong agro-industrial base and a citizenry which understood that infrastructure and production were the pillars upon which the economy stood. Today, those pillars have been severely weakened by de-industrialisation and globalisation, and people blinded by the myth that economics is based upon finance. Rather than hauling the bankers before a Commission to demand answers, our government is lavishing them with money and guaranteeing their liabilities, saving the banks without regard for people or the nation.

Pecora's efforts were rewarded with the passage of the Banking Act of 1933, commonly known as Glass-Steagall, which founded the FDIC, and prohibited the mixing of commercial and investment banking.

Glass-Steagall helped keep the bankers in check, until the 1980s, when its restrictions began to be eroded; by 1999, when the commercial bank-investment bank prohibition was repealed, it was already being ignored.

Targets of a new Pecora-style investigation should also include the hedge funds and private equity funds, the derivatives trade, and the "structured finance" instruments - the collateralized debt obligations and such - which have proved such a disaster. How did these operations come into being, who protected them, and why did the regulatory and ratings systems fail so spectacularly?

Just as the original Pecora Commission paved the way for reform by showing the American people the nature of the financial system which triggered the Great Depression, a new Pecora Commission must show the public how deregulation and globalization were foisted upon the nation. It must show that the so-called "free market" system is actually a corrupt looting operation which has bankrupted our nation and our people; that the highly touted deregulation and "financial innovation" were frauds; and that only a return to the fundamentals of what was known as the American System of sovereign credit, regulation, infrastructure, and production can lead us out of this looming collapse. It won't solve all our problems, but it is a necessary step in the right direction.

Paragraph 504 of the Report of the 1937 Royal Commission into Banking stated: "... *the Commonwealth Bank...can even make money available to Governments or to others free of any charge.*" Moss in his *History of the Commonwealth Bank* adds: "*Interpreting this last and most vital statement, a letter from Mr. Justice Napier, Chairman of the Commission, received through Mr. Harris, of the Commonwealth Sub-Treasury, who was Secretary to the*

Commission, says, "This statement means that the Commonwealth Bank can make money available to Governments or to others on such terms as it chooses - even by way of a loan without interest, or even without requiring either interest or repayment of the principal"." This power has been lost following the break-up of the functions of the Commonwealth Bank and its eventual privatisation.

WWII saw total Australian Government regulation and control of the private banks and the creation of massive amounts of previously-refused credit - credit which was directed to the war effort. After Labor's John Curtin and Ben Chifley took over from Robert Menzies in 1942, the Commonwealth Bank's powers as the national bank were used to create credit to fund the war effort by purchasing Treasury Bills from the Federal Government. In the 9 years prior to 1942 Conservative Governments had suppressed the Commonwealth Bank's power to use Treasury Bills to create credit, with only a nett £5 million created leaving Australia reliant on overseas London bankers. Under Curtin and Chifley, in 1942 the Commonwealth Bank created £59 million, in 1943 £173 million, in 1944 £77 million and in 1945 £68 million. Backed by this credit creation, government expenditure which had been around £80 million for most of the 1930's, leapt to £413 in 1942, £661 million in 1943, £677 in 1944 and £599 million in 1945. Through those dirigist measures, within a very short period Australia changed from an agrarian backwater into a strong industrialised society, an agro-industrial powerhouse. Attempts to continue those controls after the war and direct Australia's productive capacity into peace-time national development were rejected by the High Court and Privy Council.

Australia last had a productive economy and a financial system consistent with such an economy during WWII.

Whilst the productive capacity Australia developed during the war continued to influence its progress for some time after the war, it was gradually dismantled with removal of protections for local industries, removal of tariffs, removal of bounties, and removal of funding for infrastructure - Australia's great Snowy Mountains Scheme was created with a legislative structure to enable funding by long-term Government credit, instead it was funded by conservative Government from annual Consolidated Revenue Budget allocations.

The funding of infrastructure without a national bank was articulated by Charles Morgan in Parliament on 14 August 1952 saying: *"...the ..Commonwealth exercises overall control of the financial resources of the country. If a factory owner wishes to extend his factory, a farmer to erect new farm buildings, or a worker to build a home, he does not do so from current income; he raises a loan and pledges his future to repay the capital so raised. Surely the same principle can be applied to national construction, particularly in relation to such important developmental works as the Snowy Mountains hydro-electric scheme, which is of paramount importance to Australia. Surely that scheme could be financed by national credit and the resources of the Commonwealth Bank, without recourse to current revenue. ... We have been able to raise millions, and even billions, of pounds for war purposes. Why cannot we also raise money for peaceful purposes? I do not think that the people will ever again believe that when man-power and materials are available money is not available."*

A similar view had been expressed by the 1937 Royal Commission into Banking which reported that *"The Central Bank in the Australian system is the Commonwealth Bank of Australia. The Bank is a public institution engaged in the discharge of a public trust. As the central bank, its special function is to regulate the volume of credit in the national interest, and its distinctive attribute is its control of the note issue. Within the limits prescribed by law (and those limits have been extended in the past when circumstances demanded it, and may be extended again), it has the power to print and issue notes as legal tender money, and every obligation undertaken by the Commonwealth Bank is backed by this power of creating the money with which to discharge it."* (Paragraph 503)

Australia lost its machine-tool industry including the ability make the machines which in turn made the machines for manufacturing, it gradually lost its manufacturing capacity and secondary industry and has again become a provider of raw materials and primary industry

products to become a largely services economy. It has effectively reverted to a colonial status, no longer sovereign, but dependent upon international financiers and cartels.

The consequences for Australia are exemplified by Australia's loss of its aluminium smelting capacity. Without aluminium smelting, Australia would be left exporting only the raw material bauxite, robbing the economy of immense wealth. A 1970 Cabinet paper calculated the difference in exporting aluminium vs. processing aluminium, in 1970 dollars:

- * exporting 1 million tonnes of bauxite, the raw material, earned \$5 million;
- * processed one step into alumina earned \$27 million;
- * processed again into aluminium earned \$125 million;
- * and processed finally into aluminium products earned \$600 million.

The same applies to other raw materials. Government support for these industries is not a subsidy - the value-adding industry does subsidise the entire economy and retains the associated technologies and skills. It makes a massive contribution to our standard of living as do all manufacturing industries and should not be open to market manipulation.

The dismantling of the Bretton Woods System in 1971 when America's President Nixon took the US Dollar off the gold standard, exchange rates were floated and interest rates deregulated started an orgy of bank speculation and removed any capacity for any long-term investments in infrastructure. It lasted until October 1987 when the world experienced a crash which was worse than the 1920's crash, a consequence papered over and dealt with by substantial cash injections and the subsequent creation of various bubbles including stock and property bubbles and the current existential threat posed by Derivatives.

As Mr Daisuke Kotegawa, former Executive Director for the IMF in Japan, and a director of the Japanese Ministry of Finance stated: *"What happened in the Western world? The crisis now was triggered by the complete abolition of the Glass-Steagall Act in 1999. This policy change enabled investment banks to mobilise deposits collected by commercial banks as he source of their dealings; which sometimes could be called gambling. It also set the stage whereby the loss incurred from dealings of investment banks could be covered by the injection of public money to save the financial system. The amount of dealings by investment banks, including derivative transactions, skyrocketed. False, virtual and imaginary profits or commissions resulting from these dealings brought investment bankers extraordinary incomes and bonuses. Investment banks on Wall Street, such as Goldman Sachs, Merrill Lynch, Morgan Stanley, and J P Morgan, and in the City of London, such as Barclays, Royal Bank of Scotland, and Lloyds, enjoyed unprecedented levels of profits. .. These bubbles collapsed in 2008 with the liquidation of Lehman Brothers."* He advised that Australia's banks should be stopped from trading in derivatives and conducting other investment banking-style activity and the implementation of the G20's agenda to "bail-in" failed financial institutions should be halted.

These financial bubbles did not just magically appear, but were created and nurtured by a small army of bankers, lawyers, accountants, credit-rating agencies, consultants, and public relations flacks, the latter a category which includes most financial journalists and analysts. That is especially true of the current derivatives bubble, which began with Volcker's "controlled disintegration," escalated through the real-estate speculation - and junk bond-fuelled 1980s - and soared through the derivatives-soaked 1990s. Regulations were swept aside, accounting rules loosened, checks and balances discarded as the production-oriented economy was overrun by speculators, manipulators, and pure greed.

In 1986 Australia's banks were deregulated. Government had already split up the functions of the Commonwealth Bank and privatised it such that Australia no longer had any semblance of a National Bank and banking was left entirely in the hands of the largely de-regulated private banking system. Even the various State Banks had by this time also been privatised and were in the hands of the private banks.

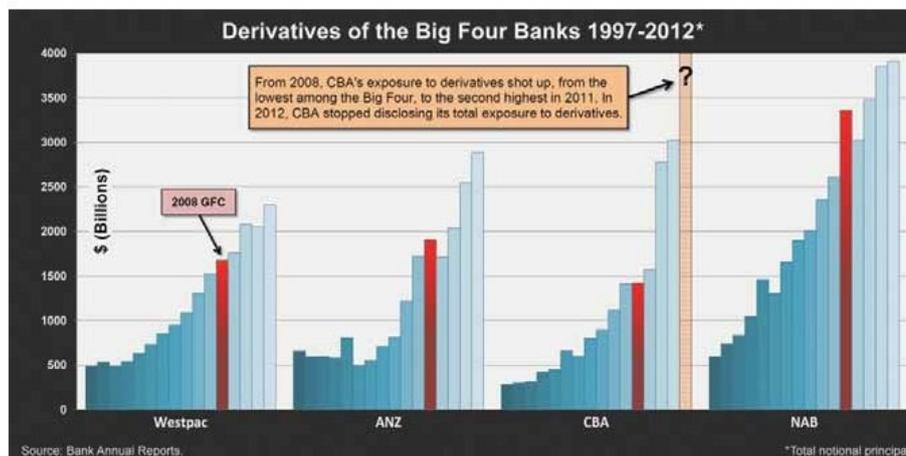
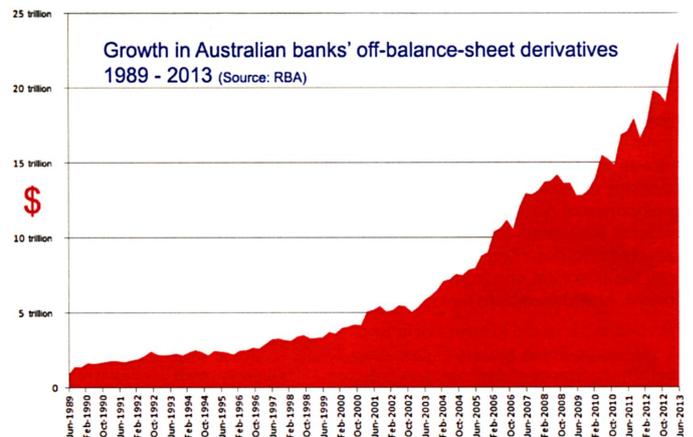
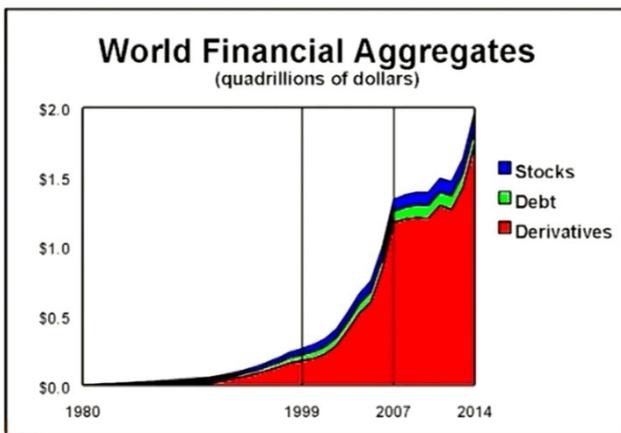
Australia's banks began borrowing large amounts of foreign capital which has created bubbles, including the current property bubble and made the banks dependent upon overseas capital inflows such that Mr Murray, the Chairman of the Committee, could recently advise a

Melbourne public hearing that “Now if we are dependent on foreign capital, we cannot go and say to the capital markets of the United States and Europe, and their regulators, that ‘don’t mind us, we are going to have our own set of regulations irrespective of what you say’”.

Without a sovereign monetary system, Australia is not a sovereign nation. When asked at that meeting “But does that mean we’re not a sovereign nation?” Mr Murray confirmed *we are not*.

The common element behind all of those actions which have reduced Australia to its current status has been a belief in the power of money in and of itself. Money was seen as wealth in itself and no longer needed any relationship to physical goods or processes. The extreme example was Derivatives which of the very nature are not related to anything other than paper - in fact when first introduced they were illegal in many jurisdictions as being nothing more than gambling. Internationally, these Derivatives have now reached levels approaching 2 quadrillion dollars. World GDP is of the order of \$50 trillion such that the level of liabilities which have been accumulated in the banking system is totally unsustainable and totally unpayable and if it were a corporation would be put into immediate bankruptcy or at least bankruptcy re-organisation.

Below is a chart of world debt and derivatives exposure and 2 charts showing the derivative growth and exposure of our Australian banks.



In the light of the above, I am at a complete loss to understand on what basis the Committee in its Interim Report can suggest that:
“Although Australia’s financial system performed reasonably well through that period of

acute stress..” whilst acknowledging that to achieve such an outcome for Australia’s banks, it was necessary that “the Government intervene.. in the form of wholesale and deposit guarantees, and provided support for the securitisation market. Deposit guarantees and direct support for markets departed from the Wallis Inquiry principle that the Government should not provide guarantees in the financial system.” and in relation to Derivatives: “To help address these risks, significant reforms such as improving the transparency of over-the-counter (OTC) derivatives have been introduced since the GFC. However, this has also moved derivatives from banks into the shadow banking sector. Globally, the increasing use of shadow banking has the potential to generate systemic risks. However, because of the small size of the shadow banking sector in Australia, risks to stability in Australia remain limited.”

Mr Murray sought to allay fears as to the banking system’s exposure to Derivatives by saying: *“This derivatives stuff. Firstly what we look at the nett derivative position in the bank. Derivatives can be used for all sorts of things. Mostly in the Australian system derivatives are used to manage the risk inside the bank. And that is a valid reason to use derivatives. They are well understood by the regulators. There is capital put aside for the risk of derivatives and it's true they've got a bad name because of the structures that were used in the Sub-Prime crisis in the United States. But it doesn't mean that they are universally bad things. And there is a lot understood about them.”*

In view of the position taken by the Committee in relation to Derivatives, which are in fact presently the greatest threat to the Australian and international financial system, I wish to deal with the fundamental nature of Derivatives in some further detail.

Derivatives comprise an estimated US\$2 quadrillion of the global financial bubble. No one knows for sure, because there is no centralised accounting of derivatives even within nations, let alone globally. The textbook definition of a derivative, is a financial instrument, the value of which is based on the value or values of one or more underlying assets or indexes of assets. Derivatives can be based on equities (shares), debt (bonds, bills, and notes), currencies, and even indexes of these various things, such as the Dow Jones Industrial Average. Derivatives are sold and traded either on a regulated exchange, such as the Chicago Board of Trade, or the Australian Stock Exchange or the SFE Corporation in Australia, one of the largest derivatives exchanges by volume in Asia, or off the exchanges, directly between the different counter-parties (banks, insurance companies, hedge funds, etc.), which is known as "over-the-counter" (OTC). Allegedly, the purpose of derivatives is to reduce the risk inherent in fluctuations of foreign exchange rates, interest rates, and market prices. In fact, derivatives *are* the risk, and have played a crucial role in destroying the world's physical economy.

A generation or so ago, when people still thought in terms of the real, physical economy, the essence of derivatives would have been clear: it is the difference between investment (related, ultimately, to the actual physical economy), on the one hand, and gambling or speculation, on the other.

The instruments which "underlie" derivatives - shares, bonds, commodities, money - represent a claim, usually through ownership, on wealth produced in the real physical economy. Such claims can be purchased. Thus, shares in a company can be bought, as can bonds issued by governments or corporations, or hard commodities produced by agriculture, forest industries, or minerals extractors and refiners.

The instrument so purchased provides a means by which the wealth produced may be turned into money. In the case of shares, this may take the form of the company's dividend payment, the part of after-tax profits distributed to shareholders, or it might take the form of capital gains realized through the appreciation of the shares' value. Formerly, such monetisation, or potential for monetisation, would have been more or less directly related to the economic performance of the company, in contributing to an increasing over-all rate of wealth generation through productivity-enhancing increases in the powers of labour. So, too, are bonds directly related to economic activity, though where shares represent equity ownership.

bonds represent indebtedness. The interest paid corresponds, more or less, to the dividend yield of a share. And, like shares, bonds can provide capital appreciation.

A generation ago, such financial instruments were the means for transforming economic surplus into monetised net profit. "Hard" commodities (upon which derivatives may also be based) are different: they are bought and sold so that production might proceed. Recognising the danger in gambling-style speculation on commodities, options in agricultural commodities were banned in the U.S. in 1938 under President Franklin Roosevelt, and were not legalised again until 1983, under financial deregulation.

Purchases of shares and bonds would once have been seen as investments for the long haul. Trade in commodities would have been seen not as investment, but as purchases and sales.

With derivatives, we move from investment, and the purchase and sale of hard commodities, to pure speculation on the future price or yield performance of what were once investments, and relatively simple, economically necessary transactions.

All derivatives are actually variations on futures trading, and, much as some insist to the contrary, all futures trading is inherently *speculation* or *gambling*. Thus, until late in 1989, all futures trading, of any sort, was outlawed in Germany, under the country's gambling laws. Such activities were not treated as a legitimate part of business activity, just as, back in the days when society was much more sane, gambling itself used to be seen as an asocial, harmful activity. In 1993 the Australian Securities Commission issued a draft report warning that criminal sanctions for illegal gambling could well be applied against the big derivatives players such as Westpac Bank, the Australian Wheat Board, Bankers Trust Australia, Macquarie Bank and others. Advice provided by the huge corporate legal firm of Mallesons Stephen Jacques to their clients in April 1993, warned that most derivatives trading in Australia was probably illegal.

There are two types of futures trading; each can be applied to each of the instruments, like shares and bonds, which, bought directly for cash, monetise what used to be after-tax profits. The first type is, as it were, a second step removed from economic activity as such. This is futures trading per se: contracting to buy or sell at a future date, at a previously negotiated price. Here the presumption used to hold, that commodities, for example, would actually change hands for money, as the agreed-on contracts fell due.

The other kind of futures contract, called an option, moves another step further away from economic activity as such. Now what is bought or sold is the right, but not the obligation, to buy or sell a commodity, share, bond, or money, at a future price on an agreed-on date.

Where the futures contract speculates on what the price that would have to be paid against delivery will be, the option simply speculates on the price.

At yet another step removed from economic activity per se is an index. An index is not the right to buy a commodity or share in the future which is traded, but the future movement of an index based on a basket of shares, commodities, bonds, or whatever. To re-emphasise, you are now far, far removed from the physical economy, and merely betting on whether the values of indexes (mere numbers in electronic hyperspace) or future prices in some piece of paper, will go up, or go down. There is no difference whatsoever in this, versus betting on either the red or the black in roulette. However, it is much worse than that, because derivatives suck money out of investments in the real economy into pure speculation. Due to the principle of leverage, they can return anywhere from a "modest" 15% per annum, to 2000% or more, so who would invest in real production, which might only return 5-6% per annum? Thus, we have US\$2 quadrillion trillion in debt worldwide, but farmers or industrial entrepreneurs frequently can not get a loan at all, or, if they do, they have to pay exorbitant interest rates, which effectively loots their business. One of the reasons why the concept of derivatives - which people would view as insane in a healthy, functioning physical economy - are viewed these days as "normal", is because great masses of the population of Australia and other western countries have themselves become inveterate gamblers, either in gambling

itself, or in that other form of gambling known as the share markets - a form of mass psychosis. It was for good reason that gambling used to be illegal.

Look, for a moment, at this comparison of gambling and derivatives. First, imagine that you are gambling entirely with borrowed money. If you win, your winnings are "free money", because you put up no money in the first place. However, if you lose, you may have to pay some steep consequences (depending on how much you borrowed), having to get a second job to pay off your gambling debt, selling your house, etc.

Borrowing money to gamble is a simple form of "leverage". which is the essential principle behind derivatives. For a rising market, that seems to work well. Take the recent hyperinflating property markets in Sydney, Melbourne, Hobart or many other major cities. For years now, if you had borrowed most or all of the money you needed to buy property (or shares, for that matter), you could almost be assured of paying back your loan and making a profit, because, as a result of the speculative bubble, property prices were constantly rising. However, much like the Dutch tulip bulb craze of the 17th Century, any speculative bubble has to pop, sooner or later.

The derivatives business is very similar, in that no one ever pays for the face value (notional principal amount, as it is called) of the derivatives contract, but only a small portion of it, the margin (like buying shares on margin). For instance, if I buy a \$1 million derivative on margin for \$10,000 - 1% - then sell it for \$11,000, I make a \$1,000 profit without ever having to come up with the \$1 million. If the price goes down, and I sell it for \$9,000, then I lose \$1,000. This is the way the derivatives players figure their risks. And, if you are buying and selling huge numbers of contracts, as derivatives traders frequently do, this quickly turns into a lot of money.

This process works, after a fashion. As long as there is someone out there who wants to buy your derivatives for something near what you paid for them, you can survive, Should the price drop below what you can afford to cover, you go bankrupt, but the market itself survives. But what happens to this pyramid scheme when there are no buyers?

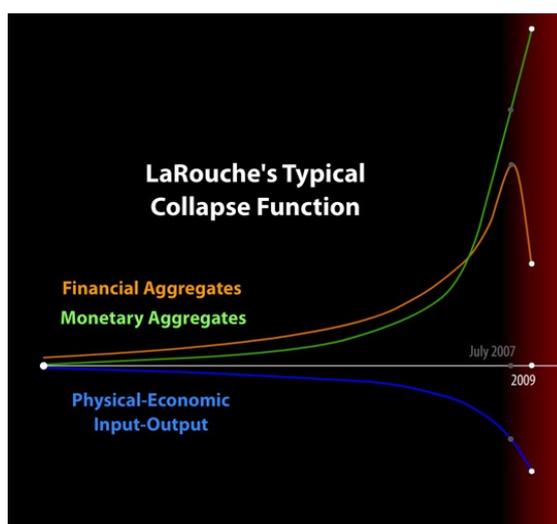
When there are no buyers. everyone who holds derivatives is suddenly liable for the face amount: Your \$10,000 has bought you \$1 million of debt, which you can't pay. You're broke, and therefore your creditors are broke, because you can't cover your debts to them. What erupts, is a chain-reaction collapse. The leverage which allowed the bubble to expand so rapidly, changes to reverse leverage, and the system disintegrates, virtually overnight.

Look at a real life example, that of the infamous U.S.-based Long Term Capital Management (LTCM) hedge fund, whose collapse in 1998 has been widely admitted to have almost blown out the entire world monetary system, which was hanging by a thread for days. LTCM used \$2.2 billion in equity put up by its original investors, to borrow some \$125 billion. It then used that \$125 billion to enter into derivatives contracts with a notional value (face value) of \$1.25 trillion. LTCM was therefore able to leverage each dollar of equity into at least \$57 in assets, and \$568 in derivatives bets, winning enough to pay off its borrowings and book huge profits - until it collapsed.

Just as LTCM's profits were multiplied through leverage while it was winning, its losses were multiplied through reverse leverage when it lost its bets: losses on its trillion-dollar derivatives portfolio wiped out its equity in a matter of weeks, leaving it unable to pay its debts, forcing its creditors to foreclose. The geniuses who ran LTCM had just the year before won the Nobel prize for economics, for coming up with a "sure-fire" formula for derivatives speculation. This process of reverse leverage is now dominating the global financial markets. The trillions of dollars of notional financial values which have disappeared, have triggered substantial losses throughout the system. The system itself, has switched from expansion and inflation, to contraction and deflation; from maximizing income, to minimizing loss. The commercial banks, facing heavy losses on their own derivatives trading and on loans to other speculators, are increasing their demands for collateral to hedge funds and other lenders. And the banks are in an extremely precarious situation themselves. The huge JP Morgan Chase in

the U.S., for instance, had a derivatives exposure so great, that a loss of just 0.16% of its derivatives portfolio would wipe out its then entire \$43 billion in shareholder equity. When the banks demand more collateral of the hedge funds, they, in turn, have to sell assets to meet the demands of their lenders. In a collapse of world share and bond markets, many of these assets are sold at a loss, worsening the financial problems of the sellers. Since selling into a declining market tends to drive the market down even further, the entire process turns into a vicious cycle, in which selling to cover losses creates more losses, which requires more selling, and so on.

The best way to understand this whole process is through the now-famous "Triple Curve" function, which physical economist Lyndon LaRouche designed in 1995 to help people understand why, under the rules of speculation-driven globalisation, the world monetary system necessarily had to collapse. There are three intersecting curves: financial aggregates (shares, bonds, derivatives. etc.), monetary aggregates (money supply) and the actual physical economy. (These curves do not represent actual numbers, but trends.) As the speculative bubble in financial aggregates grows, in order to keep it from popping, the central banks have to pump in newly-created money to keep the system liquid (i.e. buying and selling these massive amounts of financial aggregates, such as derivatives, requires more actual money).



This is what Alan Greenspan at the U.S. Federal Reserve Board did throughout all 2001, for instance, when he lowered the interest rate 11 times, in order to pump more money into circulation and the current "quantitative easing". This is the "wall of money" phenomenon, where the central banks throw a wall of money at the speculative bubble, in utter panic that it will blow out. At a certain point, the growth rate in the amount of money which must be pumped in to keep the system afloat, becomes larger than the rate of growth of the financial aggregates themselves (where the monetary aggregates crosses the financial aggregates curve), and Weimar Germany 1923-style hyperinflation sets in, where you had to take a wheelbarrow of money to the store to buy a loaf of bread. And all this time, the growing bubble sucks money out of the actual physical economy (the lowest curve) which is what actually sustains the paper in the first place, whether money or financial aggregates. It is like a five-hundred pound flea on a dog: sooner or later, it will suck its host dry, and then where will it be? The biggest component of financial turnover is derivatives.

Let's take an example of an actual derivative, an interest rate swap. This one is very close to home, since it is the derivative through which the Australian Treasury managed to lose a staggering \$5-6 billion.

The June 2002 Reserve Bank of Australia Bulletin defines an interest rate swap as "an agreement between two parties to exchange interest rate obligations over a period of time. In its most common form - a fixed-to-floating rate swap - the parties agree to net off a fixed rate payment against a floating rate payment, with the difference being paid by one party to

another. While swaps can be used for a number of purposes, one common use is to hedge exposure to interest rate movements. As an example, assume the two parties to the swap contract have differing views on the way interest rates will move. One party may have a floating rate liability and will be worried that interest rates will rise (making its obligation more expensive.) To protect against this eventuality, it can exchange its stream of floating rate payments with a fixed stream so as to 'lock in' existing interest rates. The other party would obviously adopt the reverse strategy. If interest rates rise, the party with the original floating rates obligation is compensated by the party with a fixed-rate obligation and vice versa if interest rates fall."

In the case of the Treasury's gambling, it agreed to swap obligations to pay interest in Australian dollars, for obligations to pay interest in U.S. dollars, a so-called cross-currency interest rate swap. Since the Australian dollar fell from around 80 U.S. cents when the deal was made down into the 50's, the Treasury lost, big-time.

Treasury learned from the experts. In 1987, they brought in the world-famous Barings Bank to show them how these exotic new things, derivatives, worked. A few years later, in 1995, Barings went bankrupt because of its speculation in derivatives, a bankruptcy falsely blamed on one 27-year old "rogue trader" in its Singapore office, the hapless ex-shoe salesman, Nick Leeson.

As noted earlier, no one has any real idea how bad the derivatives problem is, either in Australia, or globally, because no accounting standards anywhere (nationally, or in international institutions such as the IMF or the Swiss-based Bank for International Settlements) demand that such records be kept (see graphs above). Imagine, for a moment, a chart which has the categories of shares, commodities or cash noted at the top, and then, in descending order, futures, options, options indexes, futures options, futures options indexes, and swaps. Each of these gets more removed from any actual physical reality (even of pieces of paper) than the previous one. Add to that, that almost every day, new, even wilder forms of derivatives are cooked up, such as credit default swaps, total rate of return swaps, credit spread options and credit baskets. Now, do you see why the international monetary system is about to blow? Remember, all of this would have been impossible without financial deregulation. And, if you had fixed exchange rates among currencies, as in the old Bretton Woods system, there would be no point in speculating in the most characteristic kind of derivatives, the movement of currency rates vis a vis each other, the one in which the Australian Treasury lost all our money. (The Australian foreign exchange market is ranked 9th in the world by turnover, while the Australian dollar is the world's 7th most actively traded currency.) As shown above, the derivatives exposure of the Big Four banks, as recorded in their annual reports, dwarf each of the banks' equity capital.

Whilst the Derivatives issue of itself could once be dealt with in a similar fashion to the way it was dealt with by Daisuke Kotegawa, former Executive Director for the IMF in Japan, and a director of the Japanese Ministry of Finance during the 1997-998 financial crisis, effectively cancelling them, the explosion of Derivatives and their consequent corruption of the physical economy now require much more than their mere cancellation. Derivatives have sucked money from the productive economy such that the physical economy has declined to such low levels that massive re-investment in infrastructure, health, education, science and technology is required.

Mr Kotegawa recorded that *"As a director of the Ministry of Finance, I was in charge of liquidations of major financial institutions in Japan in 1997 and 1998, such as Yamaichi Securities, LTCB, the NCB. At that time, we succeeded in containing the gigantic scale of liquidations, and avoided Japan becoming an epicentre of world economic crisis. During the weekend when we liquidated these institutions, we unwound all cross-border transactions, including huge amounts of derivatives. Such unwinding was not done by the authorities of the United States and the United Kingdom at the liquidation of Lehman Brothers, which triggered the world economic crisis."*

Australia's capitulation to a deregulation scheme for its banking system together with

widespread privatisation, deregulation, free trade, and competition policy and our integration into an international banking system which is based on the same ideology has not only been an abject failure but has effectively destroyed Australia such that the financial system as it now stands needs to be totally re-defined, a Glass-Steagall type separation of banking activities introduced, a National Bank created to provide large-scale state-credit mechanisms and Australia must embark on large national infrastructure and science-driver projects. The reality is that as long as present, monetarist forms of deregulation and related free trade policies continue to be tolerated, it will be impossible to prevent a financial and economic collapse of entire nations, including Australia, and the entire planet will be plunged into the worst financial and economic catastrophe which modern history could recall since analogous Venetian bankers' policies produced the mid-fourteenth-century collapse of Europe.

As Mr Murray acknowledged at the above-mentioned meeting, for Australia to take the above steps and become sovereign, it would be necessary to *“run the economy in a very different way”*.

That is exactly what has now been recognised by nations representing almost half the planet's population.

In mid-July 2014, as the planet was being wracked by growing war horrors in eastern Ukraine, Iraq, and Gaza, and by economic depression caused by the implosion of the trans-Atlantic financial system, heads of state representing half of humanity gathered in Brazil and took the first steps toward creating a New World Economic Order. That breathtaking process is now underway among the BRICS countries (Brazil, Russia, India, China, South Africa) and Ibero-America, in which these States representing half of humanity, are constructing a new, just world economic order, based on building up the real economy, scientific and technological progress, and a vision of the future. The only thing that the alternative trans-Atlantic financial system (to which the Committee suggests we have to conform because we are dependent on the import of their financial capital) has to offer is the sacrifice of the common good, of the happiness and the life of its people, in favour of a Frankenstein monster, "the stability of the market," preservation of the banks, globalisation, and free trade to which anything and everything should be sacrificed, but which is itself hopelessly bankrupt. This system does exactly what Pope Francis says: It kills.

The BRICS Summit issued a 72-point Fortaleza Declaration which announced the formation of a New Development Bank (NDB), initially capitalized at \$50 billion, to fund infrastructure projects in BRICS and other countries; as well as a Contingent Reserve Arrangement (CRA) with \$100 billion to help nations deal with capital flight and other forms of financial shocks. China will contribute \$41bn to the pool, with Brazil, India and Russia putting in \$18bn each and South Africa \$5bn. The leaders of the BRICS nations met on July 16 in Fortaleza for the BRICS Summit, and the next day they were joined by the heads of state of South America in the capital city Brasilia. The BRICS account for 43% of the world's population and 27% of the planet's land area; when Ibero-America is added in, they jointly represent 48% of the human race, and one third of the Earth's land area.

At the summit and its numerous associated bilateral and multilateral meetings, half of humanity adopted a project that is premised on rejecting the current casino financial system, and replacing it with one providing credit for high-technology development projects; on educating and training youth to meet the growth challenges of the future; on full respect for national sovereignty, banishing the imperial policy of regime change and wars; and on explicit promotion of the common good among nations—the Westphalian principle.

“History tells us the law of the jungle isn't the way of human coexistence,” Chinese President Xi Jinping stated on July 16. *“Every nation should obey the principle of equality, mutual trust, learning from each other, cooperating and seeking joint benefits . . . for the construction of a harmonious world, sustained peace, and joint prosperity.”*

BRICS and allies are building a world system based on real value, not phony paper value. They are deciding what real value is, and they are imposing it, which is the cost of the

productive powers of labour in a changing situation.

We are now faced with two distinct systems that are operating with a different logic and different metrics: they are totally incompatible. The first system is the trans-Atlantic system to which the Committee suggests we should remain beholden: What this system holds as value is paper which of itself is absolutely worthless - such as the promise of future delivery of derivatives that the system alleges actually has value. This is the dead hand of the past, trying to stop humanity from creating any future for itself.

On the other side, we have an emerging system, incompatible with the first, which is building a market based on real value. And real value comes from, and is measured by, the development of the productive powers of labour - that is, through the introduction of scientifically created new technologies, implementing productive processes which increase the energy-flux density through the physical economy in such fashion as to immensely increase the productive powers of labour. That new system will create a process whereby the increase in energy-flux density will itself increase at an accelerating rate. This role of technological progress and scientific advance is what the human species uniquely does. Such creativity is actually the source of value in an economy, and it is the way in which our action to create the future defines present value. It is the central concept of the American System of Political Economy, on which the United States was founded.

The decisive strategic question today is whether Australia will join that emerging New World Economic Order, or will remain joined at the hip to its British Empire and financial system roots and bring destruction down upon itself as it is the rest of the world.

Many of the above ideas and details have been the subject of the researches and publications of the Citizens Electoral Council and its associates and I would commend its publications and its web site (www.cecaust.com.au) for further detail and considerations of the ideas and issues involved.

CONCLUSIONS & RECOMMENDATIONS TO INQUIRY

1. That there be no bail-in of depositors to “save the banks”.
2. That Australia must separate legitimate commercial banking functions from the speculative activities of “investment banks”, as did the Glass-Steagall law in the United States so successfully from 1933 until its repeal in 1999. Such commercial banks serving the interests of the average Australian should be backed by the government, but the speculative banks should be left to sink or swim.

A Glass-Steagall separation of essential banking from speculation. This policy is the complete opposite of bail-in. Glass-Steagall is the name of the U.S. law in place from 1933 to 1999 which protected depositors by absolutely forbidding commercial banks that held deposits from having anything to do with the Wall Street investment banks - no cross-ownership, cross-directorships, no contact whatsoever. It was the repeal of Glass-Steagall in 1999 which enabled investment banks to take over commercial banks and their deposits, so they could have a lot more money to gamble with, which led to sub-prime loans, the derivatives bubble, and the worldwide crash in 2008. There is now a big push to restore Glass-Steagall: in the U.S., where three bills are before the Congress; in the U.K., where more than 60 per cent of MPs across all parties support it, and in many other European nations. The giant U.S. bank JPMorgan Chase is leading a Wall Street counter-attack to stop Glass-Steagall, knowing that it will bankrupt their financial casino, and protect the people and the banks that service the everyday economy, from their predatory looting. Australia desperately needs a Glass-Steagall separation of our Big Four banks, which between them hold close to 80 per cent of all Australian deposits. Those deposits are in extreme danger, because the same banks are heavy speculators, especially

in derivatives, the same toxic gambling bets that caused the 2008 GFC. Altogether Australia's banks are exposed to derivatives obligations totalling in excess of \$21 trillion. Glass-Steagall will split up the Big Four, so that the deposits they currently hold end up in safe banks that aren't involved in risky speculation.

Any arguments by the banks in opposing such a separation on the basis of cost is a non-issue - the cost of not doing will be far greater and will result in the destruction of not only the banks and financial institutions but the nation itself.

It might also be noted that in an endeavour to forestall the adoption of a genuine Glass-Steagall separation, a system called "ring-fencing" has been promoted by the banking industry and was adopted last year in England based on the recommendations of an inquiry into the British banking system conducted by Sir John Vickers, the author of ring-fencing. Such a system is not the same as the banking separation imposed by Glass-Steagall which requires a total separation of the retail and investment banking sectors - no cross-ownership, no shared directors, no contact whatsoever. The Vickers "ring-fencing" is the old "Chinese walls" separation, in which investment banking and retail banking still operate in the one bank, under the same controls and under one board of directors but supposedly kept legally separate. Ring-fencing is not an alternative - as was said in the British House of Lords *"bankers are extremely adept at getting between the wallpaper and the wall. If they can find a way to get around something, they will."*

Of ring-fencing, Lord Lawson, former Chancellor of the Exchequer said in the House of Lords: *"I have always been in favour of full separation - I came out publicly in favour of it long before the Vickers commission was even set up. We know that this works. It worked in the United States for many, many years under the Glass-Steagall arrangements, and it is no accident that serious problems emerged after the Glass-Steagall Act was repealed ... Another of the things that the Vickers commission did not consider is the problem of governance. The ring-fence is a curious system, because there is one company with two subsidiaries - the retail bank and the investment bank - and we are told that they are completely separate, but they are together: There is a real question whether that model of governance is workable..."*

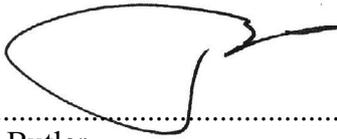
3. That to anchor such a system of private commercial banks, Australia must also establish a national bank typified by our old Commercial Bank, where our government directs credit into the real physical economy of agriculture, manufacturing, and infrastructure projects which provide for the common good, including employment opportunities for all.

Australia must return to the banking structure we had in WWII, when the government-owned Commonwealth Bank was in charge of the banking system, and regulated all of the private banks. This system was brilliantly successful: it financed the extraordinary wartime economic mobilisation that transformed Australia's economy from an agrarian backwater into an agro-industrial powerhouse with a world-class machine tool sector; and all bank deposits, in both the private banks and the Commonwealth Bank, were absolutely guaranteed. With its own National Bank, the elected government becomes the ultimate authority in the financial system (rather than the privately-controlled central bank as it is presently), and it can direct the bank to issue credit for long-term investments in the areas of the economy for which the government is responsible; namely, infrastructure, and the development of essential agricultural and manufacturing industries. Infrastructure financed with credit from the National Bank takes the cost burden off the annual budget, freeing up public resources for pensions, doctors, nurses, teachers and the other things we expect the government to fund adequately.

4. The only way for Australia to reindustrialise, and make our economy once again an agro-industrial powerhouse, is to embark on a program of large-scale infrastructure development. Plans such as major water diversion projects, including the Bradfield Scheme in North Queensland, the Clarence River Scheme to inject more water into the Murray-Darling Basin food bowl, and the second stage of the Ord River project in WA. Also a high-speed Melbourne to Darwin fast freight rail service, and a high-speed

Australian Ring Railway around the whole country. We need to utilise Australia's own abundant reserves of uranium and thorium by developing a nuclear power industry, to return to cheap electricity, but of an increased energy-density. All of these projects would revitalise feeder industries such as steel manufacturing, creating millions of jobs directly and indirectly. They can all be financed through long-term, low-interest loans from the National Bank.

Dated this twenty fifth day of August 2014

A handwritten signature in black ink, appearing to be 'R H Butler', written over a horizontal dotted line.

R H Butler

25th August 2014