Opinion

Main Street missed out on party but is footing bill

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When the United States Treasury Secretary, Henry Paulson, made an appeal to Congress for $US700 billion to bail out the US financial system, he observed that there were 5 million homeowners in foreclosure or in delinquency on their mortgages.

He observed that lax lending practices "earlier this decade led to irresponsible lending and irresponsible borrowing". With 5 million owners in default, there are millions of properties up for sale. The value of real estate is plummeting and the security for these mortgages has collapsed in value. Millions of these mortgages are now worthless. So who was responsible for supervising these lax credit practices in the US? As it turns out, no one.

The US central bank, the Federal Reserve, supervises the banking system but most of these loans were generated outside that system. They were packaged up and on-sold to investment banks, insurers and other financial institutions that are now holding the worthless paper. Those who made handsome fees lending the money have long gone, just like the borrowers. And the financial system holding these securities is in real trouble unless it can get some assistance from the good old American taxpayer.

As an Australian, I want to see the situation stabilised. Since the US taxpayer is the only one with pockets deep enough to do it, I am in favour of the package. But if I were a US taxpayer, I would not be too happy about all of this. Main Street USA missed out on the bonuses that were being paid when the party was in full swing. It only got invited around once the party had finished and someone had to pick up the bill.

When a government borrows money (as the US will do to fund the bail-out), the taxpayers get the interest bill. Their taxes will be diverted from health and infrastructure to fund the package to cover the bad debts now held in the financial system. Saving the institutions from failure is now in the interest of all concerned.

The US has a law that puts a ceiling on government debt. For this year that ceiling is about $US9.6 trillion. The ceiling will have to be lifted so the Government can borrow more to fund the bail-out.

In Australia, we don't have a statutory limit on our government debt. But then again we don't have any government debt. The Coalition government cleared all the debt in net terms. I am glad we did; I'd rather be debt free in a financial crisis than be like the US where government net debt amounts to about 50 per cent of the economy.

We also avoided the excesses of lax lending that happened in the US. Better bank practices and regular warnings from government and the regulator helped.

The US has a fragmented regulatory system with different state and federal regulators. Some institutions are regulated and some not. The action generally moves to the less supervised institutions.

To guard against this back in 1998, we established a new regulator – the Australian Prudential Regulatory Authority – to supervise all deposit-taking institutions, insurers and superannuation funds. Regardless of what you call an institution, under our comprehensive system it is subject to regulatory oversight and prudential supervision. The US needs to do the same.

Kevin Rudd told the House of Representatives before his recent trip to the US, "Australia is better placed than most economies to weather the current storm. Australian deposit-taking and insurance companies supervised by APRA are well capitalised, profitable, well regulated and they are weathering the turmoil well."

I could hardly disagree. Thirteen months earlier I told the House of Representatives: "Australian financial institutions are well capitalised and highly profitable and our prudential regulator does not see any of the problems developing in relation to them that have arisen in the US subprime market."

Mr Rudd is right to stress the strength of our regulation system. In fairness he could also acknowledge the effort of the Coalition government to eliminate government net debt. I'll bet he's very glad that we succeeded in doing that despite partisan opposition.

I think the US Congress is within its rights to put some conditions on the bail-out. It cannot afford to let the long-term lesson be that Wall Street gets the bonuses and Main Street gets the bill.

In future it wants all the players to think about the risks before they undertake irresponsible investment. They cannot assume that after the event someone will be there to save them from their own recklessness. That is a real moral hazard.