

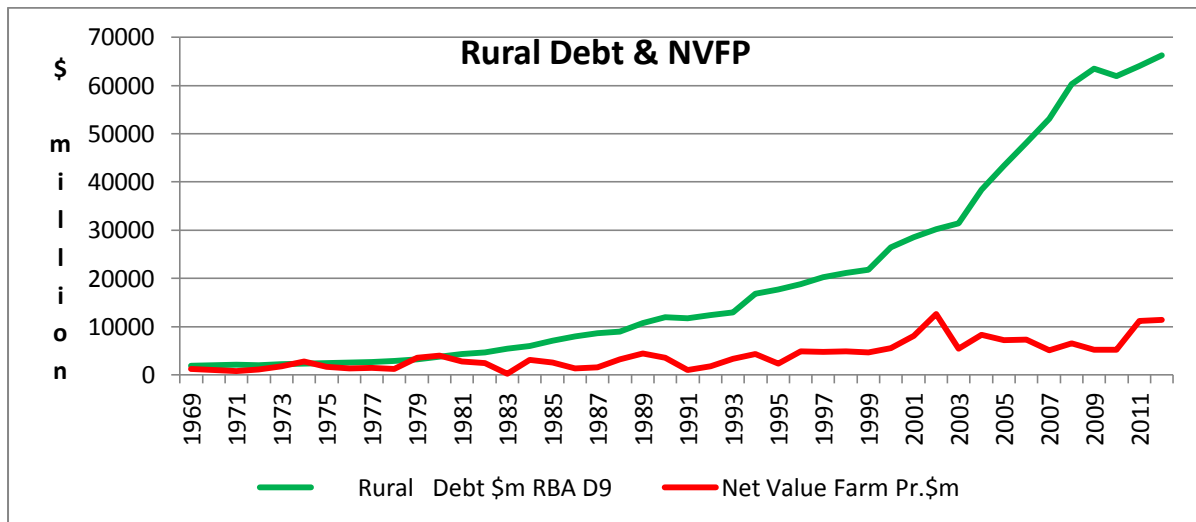
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Rural Australia : The Path Forward

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Submission to the Senate Economics Committee Inquiry into the RBA Amendment Bill to establish the Australian Reconstruction and Development Board



Across Australia, the GFC was the catalyst that exposed protracted long term policy failure. Physical characteristics of policy failure are: low commodity prices, low farm incomes, debt to equity finance, falling land values, bank foreclosures, despair and suicides. For each industry, there is a particular catalyst that triggered crisis. Widespread national drought has compounded underlying policy failure

This paper outlines the reasons why policy transformed a small farm low income problem of the 1960-70's to become a modern crisis of low income, large farm debt crisis. Implicitly, the submission raises concerns over the competence of rural leadership at all political levels. Publically available data was simply ignored as political ideology overrode sound economics. The GFC rudely exposed rural policy as little more than politically bastardised economics. A debt crisis of unprecedented levels now threatens the stability of rural Australia, its regions and communities.

A first step necessary in returning rural Australia to financial stability and profitability is a process of asset enhancement structured through the Australian Reconstruction and Development Board within the RBA. A second step must follow and that will be a change in rural policy direction; but, that step must come through the proposed White paper.

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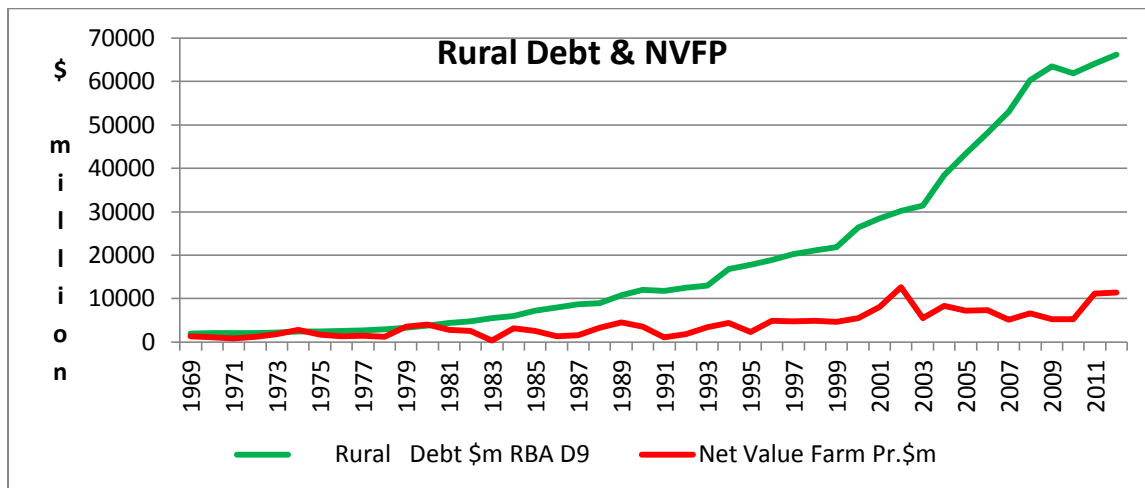
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1 Introduction; Policy Problem

Graph 1



Compiled from: NVFP, ABARES Commodity Statistics 2012

Rural Debt RBA Statistics online Table D9

Graph 1 graphically encapsulates the nature and composition of long term policy failure characterized now as a rural debt crisis. NVFP which is an approximation for net farm income excluding depreciation has basically flat lined since 1969. Rural debt rises steadily to 1993; but then, appears to develop a life of its own. The only explanation of the rapid divergence between debt and NVFP curves is debt to equity lending under a macroeconomic policy of asset inflation. Theoretical discussion of policy failure can be found in a series of papers presented at Rural Debt Round Table functions at Merredin (WA), Colac (Victoria) on 15th 16th April 2013 respectivelyⁱ, and Hughenden (Qld.) Dec. 11th 2013

The genesis of the contemporary farm debt crisis lies in the policy response to the small farm low income problem that began to emerge in Australia over the late 1960's early 1970's. "*The Australian low farm income problem first appears to have been seriously recognised in McKay's Paper*"ⁱⁱ as far back as 1967. McKay was then the Director of the Bureau of Agricultural Economics. By the early 1970's agricultural policy had become a political issue. In 1973, Prime Minister Whitlam sought to expand the powers of the then Tariff Board to create an Industries Assistance Commission which would be expected to advise on agricultural policyⁱⁱⁱ. Sir John Crawford was invited to advise on the functions, structure, membership and procedures of the proposed institution. In December 1973, the Industries Assistance Commission Act was passed.

Firstly, this submission attempts to draw together the underlying reasons for long term rural policy failure that has its primary formulation in the economic modelling and policy advice

continually provided to governments from the 1974 Industries Assistance Commission right down to its modern counterpart the Productivity Commission. This modelling assumed agriculture to be purely competitive sector. Meanwhile the non farm sector was encouraged to consolidate ownership and control. This conflict of economic theory can best be described as politically “bastardised” economics. For neigh on four decades, rural policy has ignored the moral question in economics; and, the rural debt crisis is exposing for all to see the political “bastardisation” of economics by successive Australian Governments

This submission should also demonstrate that there are no “villains” in this crisis—just different sectors working in their self interest within the policy parameters set by governments. For decades, economic theories have not been questioned by major political parties, rural leaders, academics, rural professional advisors; and, a collection of respected policy commentators. The reality of inappropriate policy is now playing out as financial dislocation in rural communities across Australia.

2 Institutionalization of Neoclassical Economics in Australia

Guidelines for the Industries Commission stressed resource allocation, adjustment to change, and integration of assistance measures with overall government policy. Policy approach by the IAC was conservative economics favouring free market efficiency and minimum government intervention^{iv}. Since its inception IAC has been restructured several times; and, today is known as the Productivity Commission.

Over 1970-72, Evans developed the first general equilibrium model of the Australian economy^v. His work became the forerunner of the IMPCT model. In 1975, the IMPACT Project was initiated to provide analytical advice on implications of social and economic change as well as policies. The project was initiated by the IAC; but, included a number of other departments^{vi}: Departments of Industry Commerce, Employment and Industrial relations, Environment Housing and Community Development, and Australian Bureau of Statistics. The Project structure comprised two models for analysis of both medium and future time horizons. The medium term module MACRO consisted of an annual general equilibrium model ORANI; and, a longer- term demographic model BACHEROO. The MACRO medium term model was structured to link sequences of annual projections. The purpose of the long term model, SNAPSHOT, was to provide analytical information on the economy at some arbitrary future point in time.

Provision of the IAC and other government departments with neoclassical general equilibrium models institutionalised market theory as the analytical basis of Australian policy analysis and development. A market clearing assumption within neoclassical general equilibrium models reinstates Say’s Law of Markets as supply and demand theory. Under Say’ Law, supply creates demand. This assumes away deficiency of demand under flexible markets. Competition, efficiency and productivity become key industry policy objectives.

3 Policy Direction and Strategy

Subsequent policy response to the low farm income problem of the early 1970’s sought to address farm viability. Neoclassical theory required a policy direction of farm build up to capitalize on economies of scale. This was expected to lift efficiency and raise enterprise productivity. Policy strategy was directed towards adjusting small inefficient farmers out of the industry through farm amalgamation. Applied policy supported farm build up through a

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system of rural adjustment. Meanwhile, the cold shower treatment was applied sector wide by withdrawal of government industry support.

Historically, rural adjustment policy dates back to latter stages of the Great Depression. In 1935, the Commonwealth adopted a debt reconstruction scheme^{vii}. Very different economic circumstances pertained in the early 1970's when debt reconstruction was adopted to address a contemporary small farm low income problem emerging across the dairy, wool, wheat and fruit growing industries^{viii}. Beginning in 1977, the original debt reconstruction policy has been replaced since by several versions of rural adjustment.

Whilst theoretical failings of rural policy are discussed in companion papers, it is suffice to say here that the theoretical weaknesses in rural policy lie in underlying assumptions of orthodox economic i.e neoclassical theory of the markets. As neoclassical models used in policy development do not reflect the behaviour of the real world, they have proven incapable of explaining the real world outcomes of the policy of farm build up accruing an ever increasing debt burden. Furthermore, economic models could not project the consequences of competitive banks chasing market share that led to debt to equity lending on a large scale.

The weakness and accompanying danger in debt to equity finance was identified in the 1994 Senate Inquiry into Rural Adjustment, Rural Debt and rural reconstruction. In conclusions on page 99, the Inquiry identified that banks were chasing market share; and, were lending on debt to equity terms. Debt to equity lending assumes unrealistically that asset prices will continue rising indefinitely. The Inquiry also found that risk margins being charged on such loans produced actual interest rates in the order of 30%. Despite these findings of flaws in applied policy, farm policy was not adjusted; but, continued on assuming farm build up would deliver economies of scale, increased efficiency and ever rising productivity. This confusion of productivity with profitability is consistent with Say's Law of Markets that assumes supply creates demand. Real world experience has proven that assumption does not hold in the real world.

Across Australia, the GFC was the catalyst that exposed the weaknesses of theory that led to policy failure. Financial dislocation from the GFC flowed back to real assets upon which farm mortgages had been raised. As debt to equity lending by banks depended on asset inflation, the GFC brought asset inflation to an abrupt end. Suddenly, farmers were asked to repay loans from income. The difficulty was that debt to equity lending had never been designed to be repaid from incomes. Consequently, overvalued rural assets were written down to more realistic market levels. The effect of falling land prices undermined the solvency of farmers who had borrowed in the halcyon days of debt to equity lending and ever rising land values.

Physical characteristics of protracted rural policy failure are: low commodity prices, low farm incomes, debt to equity finance, falling land values, bank foreclosures, despair and suicides. For each industry, there is a particular catalyst that triggered crisis.

- Northern cattlemen: closure live cattle export market.
- Wheat industry: post GFC falling land values eroding credit worthiness
- Dairy: monopoly power in retailing forcing down farm gate prices
- Horticulture: low commodity prices, cheap imports, and contracting processing sector

Wide spread national drought has compounded the underlying problem of long term policy failure. More recently, the high value of the \$AUD has been unhelpful to all export industries. Rural Australia has been no exception.

4. Economies of Scale Fails

Table 1

Political Administrations

Year	Administration
1968-71,	Gorton (Coalition)
71-72	McMahon (Coalition)
1972-75	Whitlam (Labor)
1975-83	Fraser (Coalition)
1983-91	Hawke (Labor)
1991-96	Keating (Labor)
1996-2007	Howard (Coalition)
2007-10	Rudd (Labor)
2010-2013	Gillard (Labor)
2013-2013	Rudd (Labor)
2013	Abbott (Coalition)

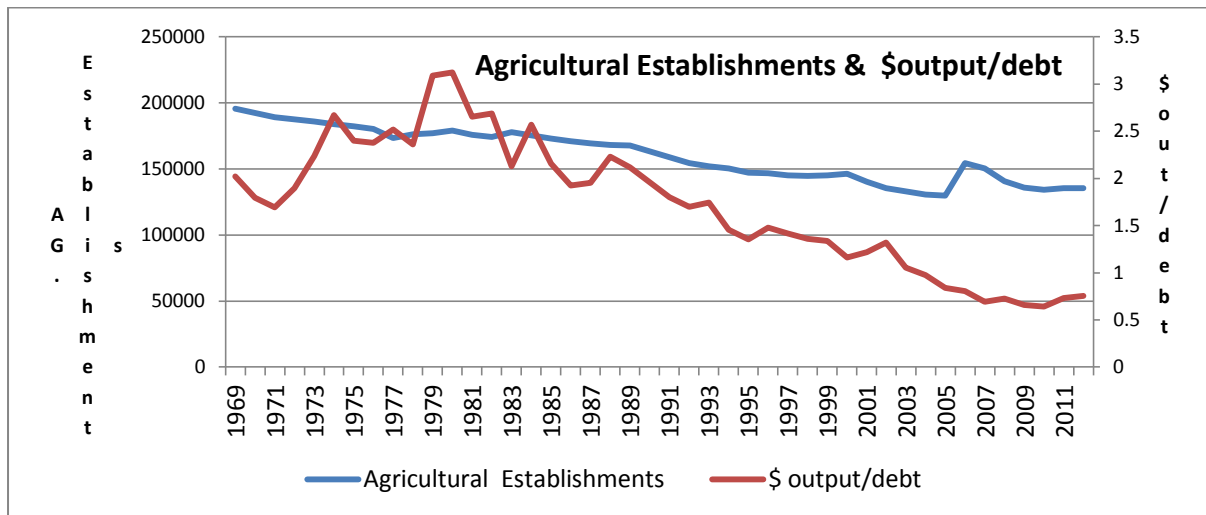
The small farm low income problem of the 1960's-1970's was a worldwide phenomenon in mature economies and produced a number of applied solutions ranging from direct government assistance by other advanced economies to Australia's structural reform programs. Australia sought to build a prosperous farming sector through farm amalgamation, economies of scale, and international competitiveness. In neoclassical theory there are three types of economies of scale which describe how output responds in the long term to a proportional increase in inputs:

- Increasing returns to scale
- Decreasing returns to scale
- Constant returns to scale

If a proportional increase in inputs expands output by more than the proportional increase in inputs, then returns to scale are increasing. However, if the level of output is less than the proportional increase in inputs, then returns to scale are decreasing. Should output increase by the same proportion as the increase in inputs, then returns to scale are said to be constant. For Australia's farm build up solution to be successful in overcoming the small farm low income problem, economies of scale had to be either increasing or constant returns to scale.

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Graph 2



Compiled ABARES 2013, Table 21,

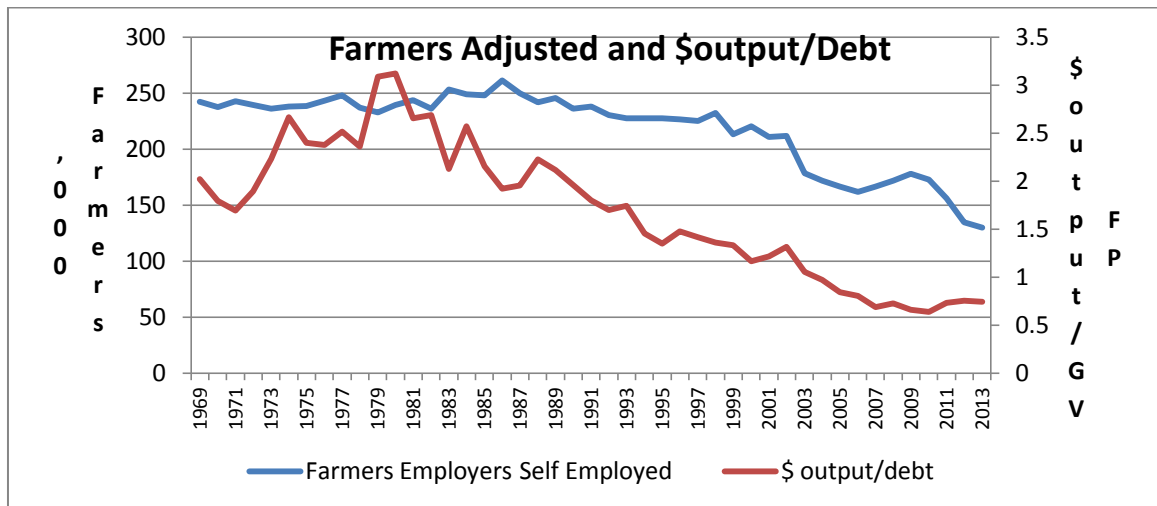
Rural Debt RBA Statistics online Table D9

Graph 2 demonstrates that the dollar value of output supported by debt declines as the number of farm establishments contract. This suggests an industry facing imperfect markets; and, farm businesses operating under decreasing returns to scale. Decreasing returns to scale imply that an optimum production level will be reached beyond which profit levels decline until continued production generates losses. It follows that rural adjustment policy under a deregulated industry structure, could never be successful over the long term under decreasing returns to scale and the withdrawal of government intervention. For policy direction to remain unchanged for over four decades reflects badly upon the competence of rural political representation at all levels.

The next graph shows empirically the same policy outcome from the perspective of farmers exiting the sector. Contraction of farmer numbers appears to have produced a perverse policy outcome. Again, from the curves, decreasing returns to scale are evident over the long term. Both graphs of adjusted establishments and farmer numbers provide the same consistent picture of policy failure

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Graph 3

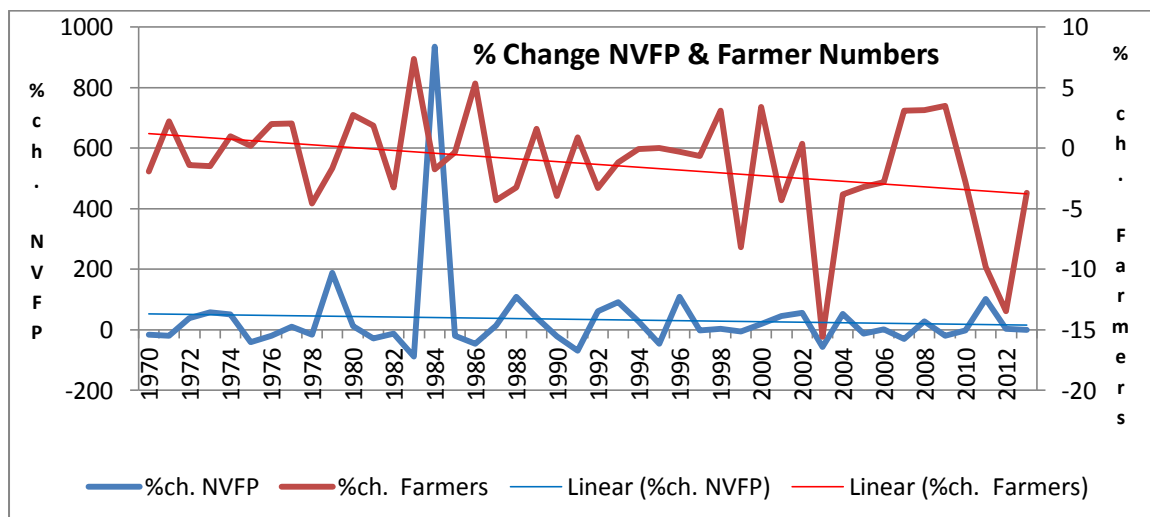


Compiled from ABARES Commodity Statistics 2013, Table 21; and RBA online Rural Debt Table D9

Both Graphs 2 and Graph 3 confirm that rural adjustment policy produced a perverse policy outcome. In 1986 farmer numbers had peaked at 261,300; but, by 2013 farmer numbers had contracted to 130,000. In percentage terms, between 1986 and 2013, 61.2% of 1986 farmer numbers had exited the industry. Between 1986 and 2013 the annual wastage of farmer numbers averaged 2.6% compound. The heaviest farmer wastage years were under the Howard Administration which shows an annual 2.8% compound farmer loss.

As rural adjustment was financed by debt, the other side of the adjustment equation is the level of output supported by each dollar borrowed. \$output/debt peaked in 1980 when each dollar borrowed supported \$3.12 of production. The lowest value of output supported by each dollar borrowed bottomed in 2010 at 64^c. That collapse in \$output/debt represents a 452.2% contraction in agricultural production supported by each dollar borrowed. Annually, this breaks down to a 4.7% annual compound contraction in production per dollar borrowed. Some meagre recovery had emerged by 2013 when \$out/debt had increased to 74^c

Graph 4



Compiled from ABAREs commodity statistics 2013, Tables 13, and 21

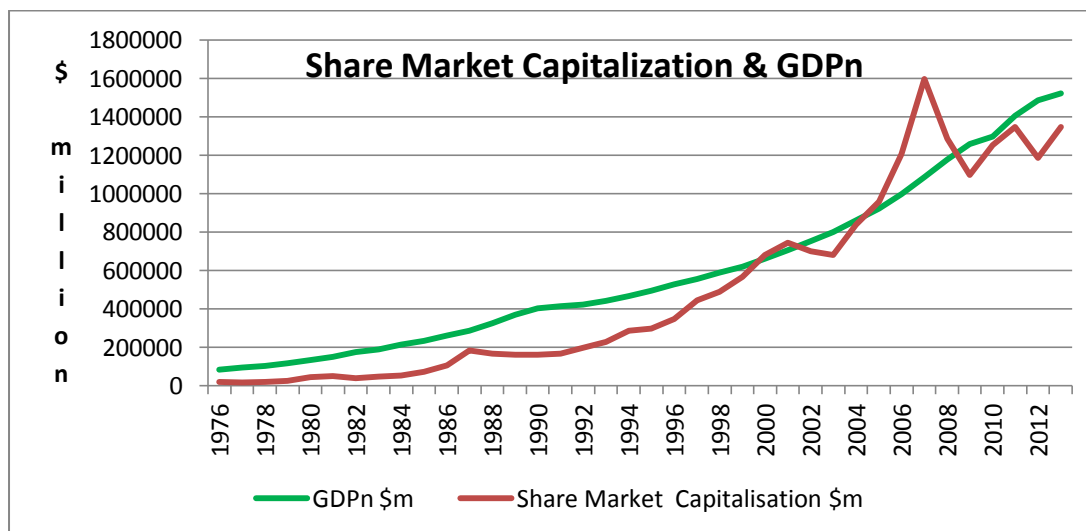
Graph 4 illustrates the long term rates of change in both farmer numbers and the NVFP. The long term trend lines show the comparative failure of farm policy to deliver rising profitability. Whilst the rate of change in farmer numbers leaving the sector is highly volatile, farmers leaving the sector decline over time. However, the periods of heavy farmer loss can be clearly identified against Administrations.

The NVFP rate of change trend line also declines. This is contrary to policy expectations that a program of structured adjustment of small farmers out of the industry would raise both efficiency and productivity; and hence, farm profitability. The curves suggest both productivity and efficiency failed to respond as theory had predicted. The curves though are not inconsistent with a sector operating under decreasing returns to scale. Rural adjustment it appears pursued neoclassical theory models and chose to ignore real world policy outcomes.

That is explainable when the supply and demand theory of neoclassical philosophy is understood. Say's Law of markets better known as supply creates demand is necessary for neoclassical models to run. Say's law is recognized in the models by the assumption that all markets clear. This means that supply will always find a market at market clearing prices which assumes a normal profit. In other words, there can never be a failure of demand. Consequently, real world market failure is excluded from the models by the assumption that all markets clear

5 Asset Inflation & Debt to Equity Lending

Graph 5



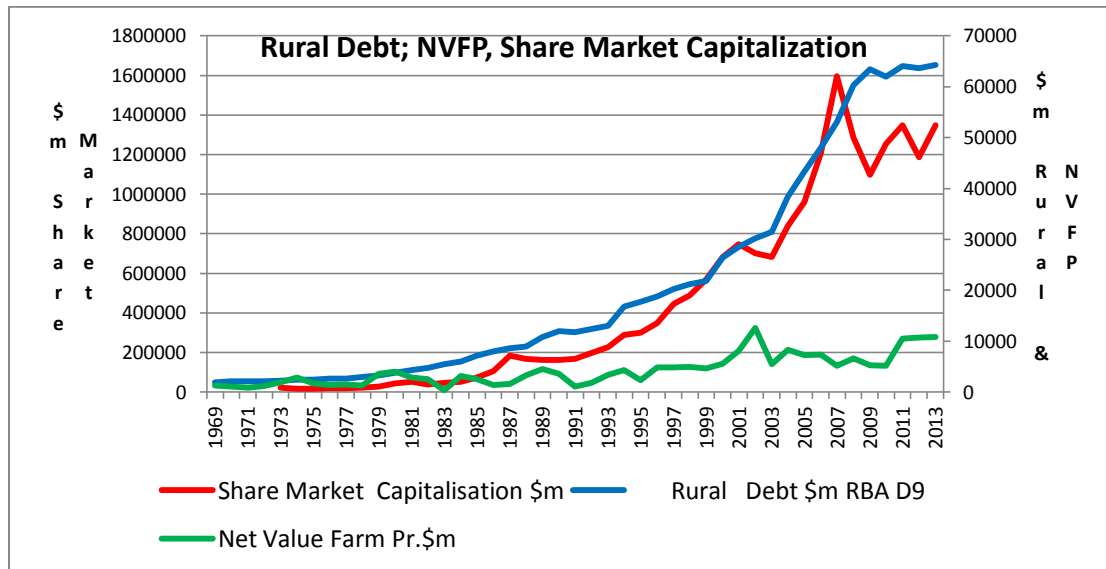
Share market capitalization Compiled from RBA Statistics Bulletins and online Table F7

GDP from ABARES commodity statistics 2013 Table 1

Western economies used asset inflation to recover from the economic dislocation of the 1980's. In economic literature of the time, a macroeconomic policy direction of asset inflation is referred to as "financialization of households"^{ix}. The objective behind this policy strategy

was to stimulate economic recovery through consumption expenditure. The policy strategy was to increase household wealth through asset inflation. It was implicitly assumed that rising wealth would encourage households to finance consumption through debt. The changing relationship between the GDP and share market capitalization curves suggests Australia was a member of the asset inflation club.

Graph 6



Compiled from: ABARES commodity statistics 2013, Table 13 Farm Returns,

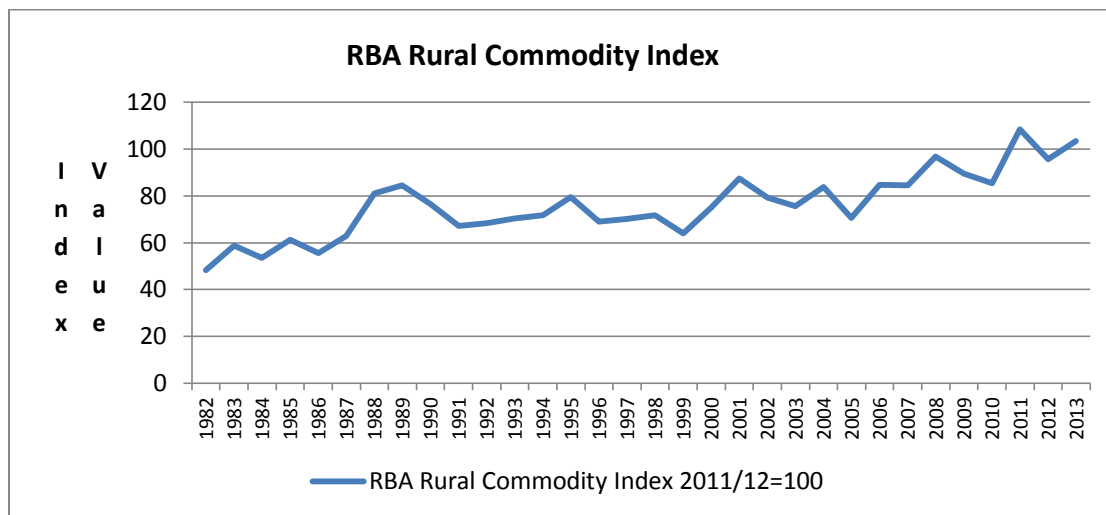
RBA Statistics online, Rural Debt Table D9, Table

Share market capitalization, RBA Statistical Bulletins; and online, Table F7

Graph 6 shows a definite disengagement between rural debt and NVFP as early as 1983. From 1983 onwards, there emerges a strengthening relationship with asset price movements in the wider economy as represented by the share market capitalization curve. By the early 1990's, rural debt shows no relationship to NVFP or capacity to repay debt from income. Rising asset inflation appears to be the only reasonable explanation underwriting the level of rural lending.

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Graph 7



Compiled from RBA Statistical Tables online Table G5

From Graph 7, financial dislocation that beset rural Australia can be traced out by the movement of the rural commodity index curve. The RBA Commodity Index had been steadily rising from the early 1980's to peak at 86.1 in November 1989. By February 1991, commodity prices had fallen to an index value of 59.9 before rebuilding. This was a 30.4% contraction in rural commodity prices. It would be February 2001, before rural commodity prices regained the level of 1989. Consequently, rural Australia was in severe recession for over a decade.

At the same time as commodity prices were collapsing, number of market orientated policy decisions were implemented that affected two major rural industries: wheat and wool. In 1989, orderly marketing of wheat ceased. In 1993, the Reserve Price Scheme for wool was terminated. Internationally, the Sino Soviet Union collapsed affecting the international markets for Australian commodity prices^x. Between 1989 and 1993, the auction price for greasy wool fell from 647.3^c to 313.5^c. The unit value of wheat fell from \$212 a tonne in 1989 to \$132 a tonne in 1993. Meat was not affected until later in the 1990's ;but, the averaged live weight weighted saleyard price for beef fell from a peak of 222.6^c a kilo in 1994 to 138.9^c in January 1997. Whilst broadacre agriculture was facing severe market dislocation, political enthusiasm for market economic theory remained unabated.

Other policy decisions affecting agriculture were made in Prime Minister Hawkes' March 1991 Industry Statement. He undertook to reduce remaining agricultural assistance in line with the reduction in tariffs for manufacturing. By the mid 1990's, the pork industry was in trouble with Canadian imports of processed pork. Prime Minister Keating commissioned the Hilmer Report on Competition Policy. This report was handed down in 1993; but, removing orderly marketing for dairy and poultry were left to the Howard Administration to implement.

As a consequence of policy decisions and international events, the percentage of debt to NVFP rose from 239% in 1989 to 387.3% in 1993. By mid 1993, the Senate Rural and Regional Affairs and Transport Committee decided to launch an inquiry into Rural Adjustment, Rural Debt, and Rural Reconstruction. In December 1994, the Senate Rural and

regional Affairs and Transport Committee published its findings. In conclusions at the end of Chapter 4, the Report makes this comment

“There is little doubt that following deregulation in 1983-84 the banks, in pursuit of market share in the face of heightened competition, made loans based on security levels offered by existing equity but without sufficient regard to the capacity of clients to repay”.

Senate Inquiry 1994^{xi}

Though recognized in the 1994 Senate Inquiry, It is surprising that major political parties and agro political organizations did not recognize behaviour of banks fighting for market share was a policy problem. Evidence presented in this submission demonstrates debt to equity lending continued; and indeed, gathered momentum from 1999 onwards. The only improvement in NFVP coincides with the implementation of the GST over 2001-02. The GFC brought debt to equity lending to an abrupt halt; and, that has created the need to review policy and restructure debt.

6 Originate to Distribute Banking, Securitisation^{xii}

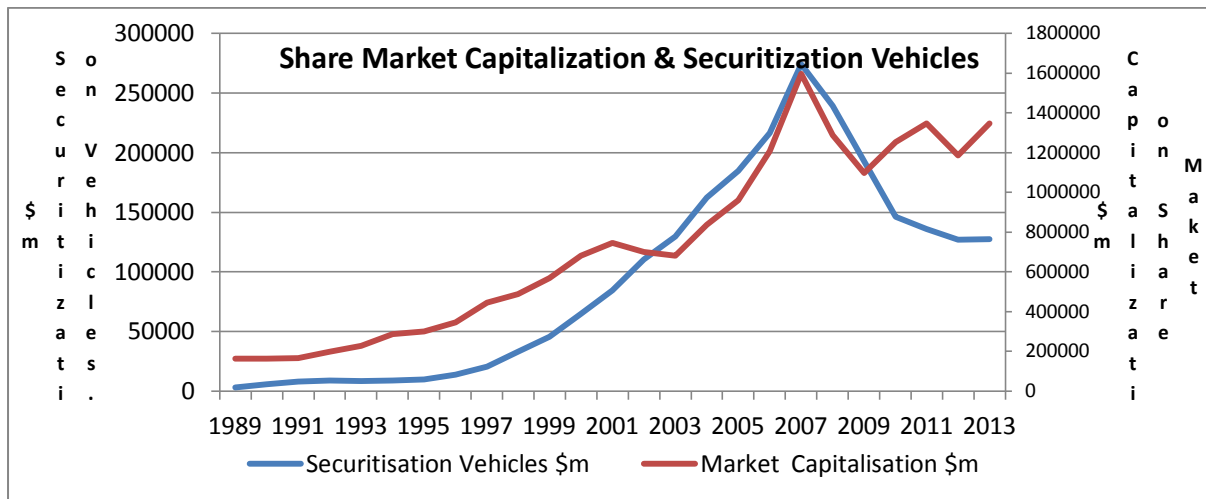
The high inflation era of the 1970's changed the traditional banking model of originate and hold to something very different. Foremost in the development of the new banking model was the US Federal Reserve Chairman Volker and US inflation over rates the late 1970's and early 1980's. At that time, unregulated financial institutions could offer higher market interest rates than the regulated banking sector. Consequently, regulated traditional banking institutions found it difficult to compete for deposits with emerging unregulated money market institutions. The bank's response was to develop the “originate to distribute” model. Originate to distribute banking captured the international banking system by storm .Abuse of this model led to the GFC and international financial dislocation of a magnitude not seen since the Great Depression.

The “Originate to Distribute” model functions by transferring the original mortgage to a special purpose vehicle (SPV) which then classifies the mortgage into classes of asset pools. The asset classes are then rated by recognised ratings agencies. Securities based upon these asset pools are subsequently sold into capital markets. The model presented several advantages to the banking sector. Reliance upon deposits for asset growth was considerably reduced whilst capital adequacy ratios became less of a burden.

A macroeconomic growth policy of asset inflation was a friendly environment for originate to distribute banking. Whilst ever government policy promoted “financialization of households”, debt to equity basis made sound business sense. Rising asset prices were not constrained to urban housing markets. Rural land prices rose in sympathy. Under a decade of collapsed commodity prices, debt to equity lending made possible the funding of rural policy based upon farm amalgamation and economies of scale. Graph 8 illustrates this point as the issue

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Graph 8



Farm Debt: RBA Table D9, online and Securitisation: RBA Table B19. Online

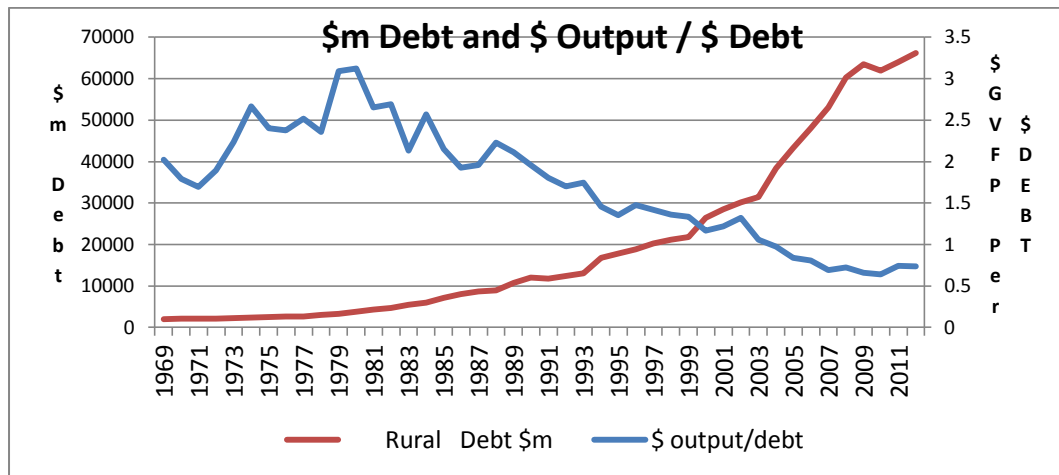
The rapidly expanding application of originate to distribute banking in Australian rural finance can be inferred from the curvilinear relationship in Graph 8. When the GFC brought an end to debt to equity lending over 2007-08, commodity prices had just returned to the real prices levels of 1989. This meant that the farm sector was facing repayment of debt to equity liabilities based upon real incomes with the purchasing power of 1989. Bank foreclosures and insolvencies became inevitable as banks moved to protect their portfolios.

The difficult head wind that made “originate to distribute” banking falter was about confidence of investors in the quality of underlying asset pools. Any asset class that struggled to maintain service commitments ceased to be attractive. Such asset classes became viewed as “toxic”. Financier lending standards to such groups of borrowers became the issue. Lack of capital market investor interest in securitised assets structured on unsound lending standards flowed back to impact upon the market value of underlying real assets – the farm. Given the relationship between the Debt and NVFP curves, it can be inferred that rural lending practices were under pressure from 2008 onwards. Simultaneously, the GFC exposed the weakness of both debt to equity lending; and, macroeconomic growth policy structured upon asset inflation.

In Australia today, the questionable assets are farm mortgages subjected to erosion of farm valuations, unsustainable debt levels, and inadequate income flows. There appears to be some wishful thinking on the part of politicians and central bankers that a re-run of asset inflation will reflate the economy; and, speculators trading financial instruments will somehow re-generate the financialization of households stimulating consumption expenditure, investment, and job creation. The reality of contemporary policy of asset inflation growth is not flowing to rural households. Farm foreclosures, insolvencies and rural suicides are proof that this model cannot provide a way forward for rural Australia.

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Graph 9



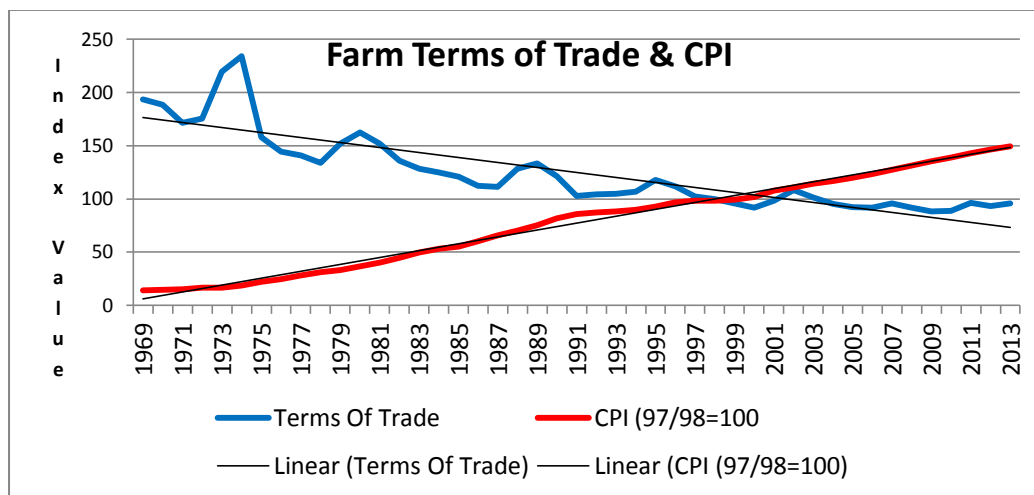
Compiled from ABARES Commodity Statistics 2012 and RBA online Rural Debt Table D9

Graph 9 provides the picture of policy failure from the financial sector perspective. Output per dollar of debt peaked in 1980 at \$3.12. From then \$output/debt curve begins a long steady decline. Significantly, by 2003-04, equilibrium between debt and output is reached where each dollar borrowed supports one dollar of output yet policy direction does not recognise the ramification for policy.

By 2010, \$output/debt had fallen to 64^c. No level of agricultural political representation appears to have understood that Australian agriculture could not remain viable if it continued to borrow to meet the demands of an unrealistic rural policy direction. Failure of the debt financed structural reform to lift farm profitability is again consistent with failed economies of scale modelling that did not reflect the real world of agricultural production.

4 Erosion of Farm Profitability

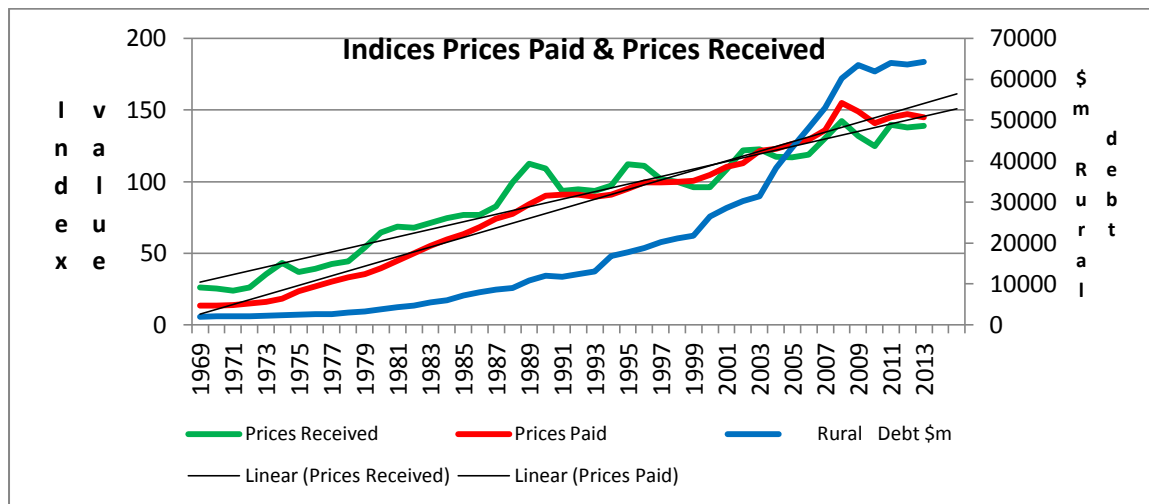
Graph 10



Compiled from ABARES commodity statistics 2013, Table 13

Farm terms of trade and CPI curves tell the story of policy failure. In the early 1970's when the policy decision was taken to restructure the farm sector to exploit economies of scale, Farm terms of Trade had a value of 219.9 in 1973. When the commodity price collapse began in 1989, Farm terms of Trade had fallen to 133.2. When the GFC occurred in 2007-08, farm terms of Trade was 91.7. A marginal improvement is evident in 2013 with the farm terms of Trade rising to 91.8. Given the long term oscillations around the trend line, the marginal improvement would be expected to be short lived

Graph 11



Compiled from ABARES Commodity Statistics 2013 Table 13 ;and RBA online Table D9

What is evident from Graph 11 is the changed relationship between output prices and input prices that occurred over 1989-91. This was the period when commodity prices collapsed. Post 1989-91, the indices remain closely aligned; but, by 2002-03, costs rise more rapidly than outprices. The new relationship between the curves becomes the norm yet bank lending to the rural sector takes on a new upward dimension from 2004 onwards.

The phenomenon demonstrated in both Graphs 10 and 11 suggests mal-distribution of market power working against rural Australia. Rural policy post 1983 sought to increase competitiveness of the farming sector. This implies a policy direction that ensured Australian agriculture more closely represented a purely competitive market structure. Certain characteristics are required to ensure a purely competitive market^{xiii} :

- A large number of buyers and sellers which ensures no one firm or buyer can unduly influence the market determined price
- Product homogeneity requires the sellers to produce a homogeneous product which by definition excludes product differentiation
- Free entry and exit of firms excludes the dominance of large producers that could be in a position to influence price.
- Profit maximization confines production to a single focus of maximizing profit
- No government intervention in the market in the forms of tariffs, subsidies, quotas or prohibitions on production

Should any one or more of these assumptions be breached, no purely competitive market can be assumed to exist.

Brought into a framework of market structure, policy failure of post 1983 structural reforms of agriculture are theoretically explainable. Whilst the farm sector was restructured to closely resemble a purely competitive market, successive governments failed to address monopoly power exercised in input and output markets for rural production. Failure of policy to pursue purely competitive structural reform in the non agricultural sectors meant that the wider economy was not a purely competitive economy. Consequently, the rural sector was placed in an economically invidious position. Providers of agricultural inputs and buyers of farm production remained able to exercise monopoly pricing power in setting prices whilst the purely farm sector had no option ; but, to accept output prices determined by monopoly price power.

This alchemist mix inevitably contributed to the erosion of profitability in the farm sector. It can be explained only in terms of “political bastardization” of economics. Implicitly, the “bastardization” of economics meant that expanding farm production must be debt dependent rather income driven. Inevitably a debt crisis had been structured within policy settings. It was just a matter of time and circumstances for it to emerge.. There have been two recognized debt crises since 1983 structural reform of agriculture: Senate Inquiry 1994 and the GFC. Policy comes down to either bad economics, or political exploitation of a sector.

Concentration of ownership and control in non-agricultural markets is not well documented. Information is scarce and difficult to obtain. However, increased market power in the retail sector is widely understood. In the late 1970's, market share dominance was distributed among three large retailing outlets^{xiv};

- Foodland warehouses, 23.5%
- Woolworths, 18.6%
- Coles; 17.5%

Coles and Woolworth market share in 1977 was 36.1%. It is now widely accepted to be in the order of 80%. Market structure of Australian retail has changed from an oligopolistic one in the late 1970's to what is now a virtual duopoly. Duopoly power in the retail sector has significant ramifications for the other three levels of the food chain: farm production, manufacturing and consumption. For example, the duopoly is in a position to bestow patronage through choice of suppliers; and, expect the chosen suppliers to jump to the tune of the duopoly. In the end choice for consumers comes down to the products the duopoly decides to place on their shelves.

Duopolies lead to undesirable corporate behaviour. For example they can engage in predatory pricing. The \$1 milk fiasco is a classic example of undesirable behaviour by powerful retailers. The ACCC seems either unwilling or unable to intervene in market behaviour by the retail giants. Perhaps, the Senate Economics Reference Committee should re-visit its 2004 Report on The Effectiveness of the Trade Practices Act, 1974, in protecting small business especially Recommendation 12 Divestiture. Divestiture was reject by the Government on the curious grounds of the Dawson Report that highly concentrated markets can be competitive.

The question implied here is in whose interest does a highly concentrated market operate?

- Self interest of the firm

- Self interest of consumers
- National interest?

If the answer is consumers, then the answer implies consumer sovereignty is sacrosanct. In economic theory certain conditions are required for consumer sovereignty to be sacrosanct. For example, resources must be allocated efficiently. This requires a perfectly competitive market and the following conditions^{xv}

- Output is produced at minimum feasible costs
- Consumers pay minimal costs which covers the marginal cost of the product
- Plants operate at full capacity
- Firms earn only normal profit

If these conditions are all present, then further conditions still remain:

- Consumer sovereignty expressed by the price system correctly reflects preference ranking of consumers
- There are no un-exhausted economies of scale in any one industry
- For a give resource allocation and technology, there is no growth or change in technology

A highly concentrated market does not meet any of the conditions necessary for consumer sovereignty to apply. It would seem, the assertion that a highly concentrated market is competitive is little more than political spin. The Australian retail sector does not meet the necessary requirements of economic theory that allows consumer sovereignty to prevail.

Theoretically, it can be argued that the highly market concentrated duopoly in Australian retailing directly disadvantages the purely competitive farm sector in domestic price determination and hence profitability.

Export marketing is also heavily influenced by monopoly power. The meat sector is one for which some information is available^{xvi}. In 2006-07, The Brazilian multinational processed an estimated 24% of Australian red meat. The US giant Cargill processed 8% of red meat production A further 6% was process by the Japanese firm Nippon Meats and the Cayman Islands Harmony Company. These foreign owned red meat processors accounted for 38% of Australian meat processing. Foreign dominance in the red meat processing section that sells mainly to export markets must raise concerns about international red meat demand being managed in the interests of the international processors supply obligations and the situation of their processing plants. The international giant car manufacturer GMH has come to the conclusion that competing against itself with manufacturing plants in diverse locations has not proven in its best interests. The question that needs answering for red meat production is in whose interest do these international companies operate: their own or Australian red meat production.

Dairy manufacturing has some limited information on market dominance. New Zealand's Fonterra and Japanese Lion manufacture around 45% of Australia's milk production. A further 5% is produced by Italy's Parmalat. Australia's Murray Goulburn accounts for around 35%. Despite this concentration in ownership and control of milk processing, Coles and Woolworths can force \$1 a bottle pricing in the domestic milk market. As the saying goes in

the bush; “something is very wrong Tallerook”. Monopoly divestiture powers would seem an imperative in any change to rural policy.

Financial Australia is little different. It is claimed that the big four banks exercise control over close to 90% of financial transactions^{xvii}. It is also argued that the four big banks have considerable overseas ownership by mutual fund arms of US international financial institutions: CBA, 29.4%; NAB 34.74%; Westpac, 32%; ANZ, 39.94%.. The issue here is the right of large international financial institutions to appoint board directors and influence management control and decisions. The question again should be: in whose interest do these powerful international institutions operate-national or self interest?

The tentacles of big business do not respect market boundaries. Listed in the NFF web site as NFF partners are: Woolworths; Bayer; Westpac; Prime Super. A reasonable question is just who does the NFF actually represent: farmers or big business partners?

To structurally reform Australian agriculture to meet the conditions of pure competition whilst leaving the non farm sector to indulge in monopoly power games has been a political abuse of economic theory. Such policy does not comply with the moral question in economics.

5 The moral question in Economics

“The moral problem is concerned with conflict between individual interest and the interest of society”

Joan Robinson^{xviii}

“In pursuit of self-interest, he (the producer)—is led by an invisible hand to promote an end which is no part of his intentions

Adam Smith^{xix}

“Frequently professional economists make pronouncements -----rooted in their value judgements that the competitive market solution is best”

Gruen 1978^{xx}

Rural Australia has endured four decades of policy devoid of any pretence to recognize the moral question in economic policy. The industry is now in financial turmoil, it is time for the moral question in economics to be reinstated in rural policy.

6 Engel’s Law

In 1857, Ernst Engel observed budgets and expenditure patterns over a large sample of European families^{xxi}. Engel found that the income elasticity of the demand for food was low. In other words, the percentage of income expended on food falls as incomes rise^{xxii}. This Law has been tested over time and is accepted as “firmly established”^{xxiii}. Recent research has confirmed Engel’s Law being just as relevant today as it was when first published. The Law applies to contemporary household consumption, national consumption; and, international trade^{xxiv}.

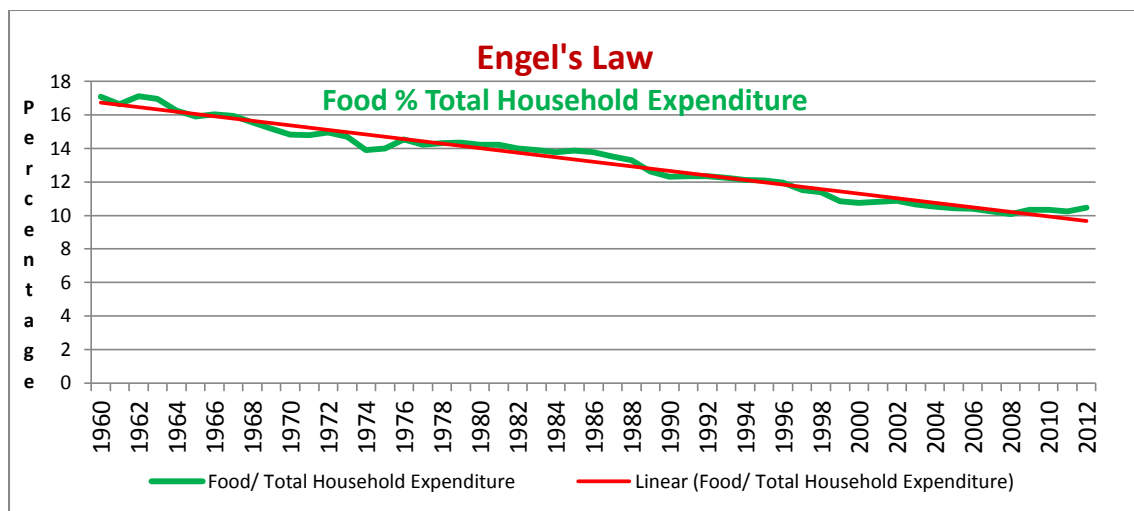
A contemporary University of Massachusetts research paper has this to say:

“Engel’s Law continues to be relevant today across countries as well as across households within countries”

Engel's Law is an empirical law of consumption which offers an explanation of why low farm income is an entrenched feature of agriculture in mature growing economies. Because this Law identifies an imperfect market structure, applied neoclassical supply and demand theory; and, trade theory based upon purely competitive market assumptions must produce perverse policy outcomes. Either Engel's Law, or Say's Law describes the real world of agriculture. They cannot both be true.

The farm sector becomes the "*meat in the sandwich*" between applied neoclassical policy based upon assumed supply and demand theory ;and, empirical evidence of research that contradicts those underlying model assumptions of neoclassical supply and demand theory. Simplistic efficiency and productivity solutions run into an Engel's Law constraint on both domestic and international policy fronts. Implicitly, Engel's Law becomes part of the explanation why the real world of agriculture operates under declining returns to scale.

Graph 12



Source: Table 8 Household Final Consumption Expenditure, Time Series Spread sheet
Publication 5206 ABS , Australian national Accounts

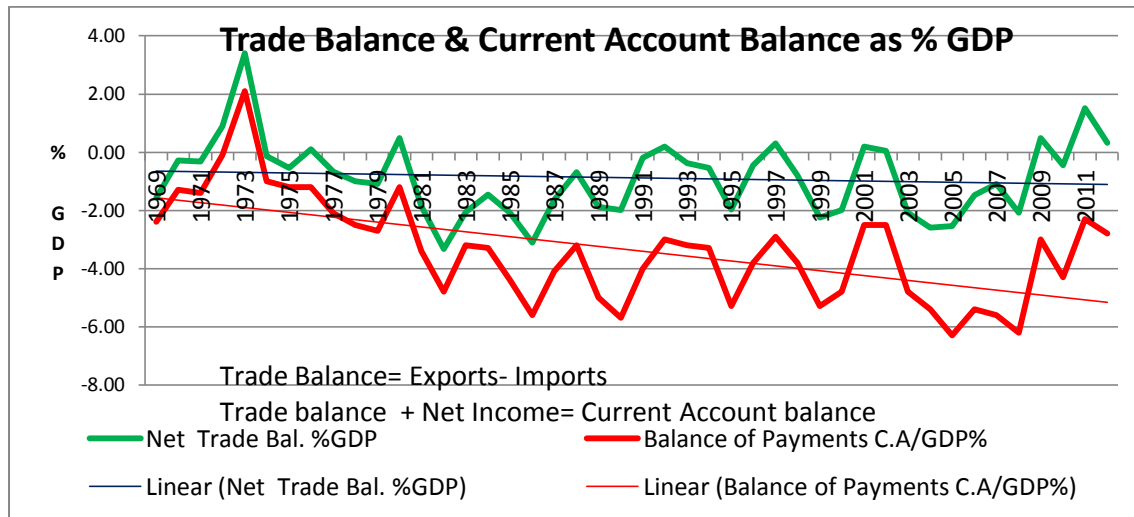
Graph 12 presents empirical evidence of Engel's Law present in Australian Household consumption patterns with the food component expressed as a percentage of total household expenditure. The graph calculated from household expenditure data understates the true nature of Engel's Law. This unfortunate situation results from inconsistent data in Australian National Accounts. Household expenditure is available in chain volume tables (constant prices) whilst household income is given in current prices. This unfortunate situation is overcome by using household expenditure as a proxy for Household income. Consequently, Engel's Law will be understated in the graph.

7 Policy Constraint: External Balance

A nation's currency value is the most important price in an economy. Resource allocation responds to changes in the value of a national currency. A low currency value stimulates export production and sales which in turn flow back to the domestic allocation and distribution of resources to export production. Similarly, an overvalued currency shifts resources into the non trade sector.

Currency stability depends upon the demand and supply of \$AUD. That demand is in itself influenced by external balance. External balance is defined as a zero balance across both the current account and capital accounts. Australia has an entrenched substantial current account deficit which requires an offsetting inflow on the capital account to maintain external balance and currency stability.

Graph 13



Compiled from: ABARES commodity statistics 2012 Table 7

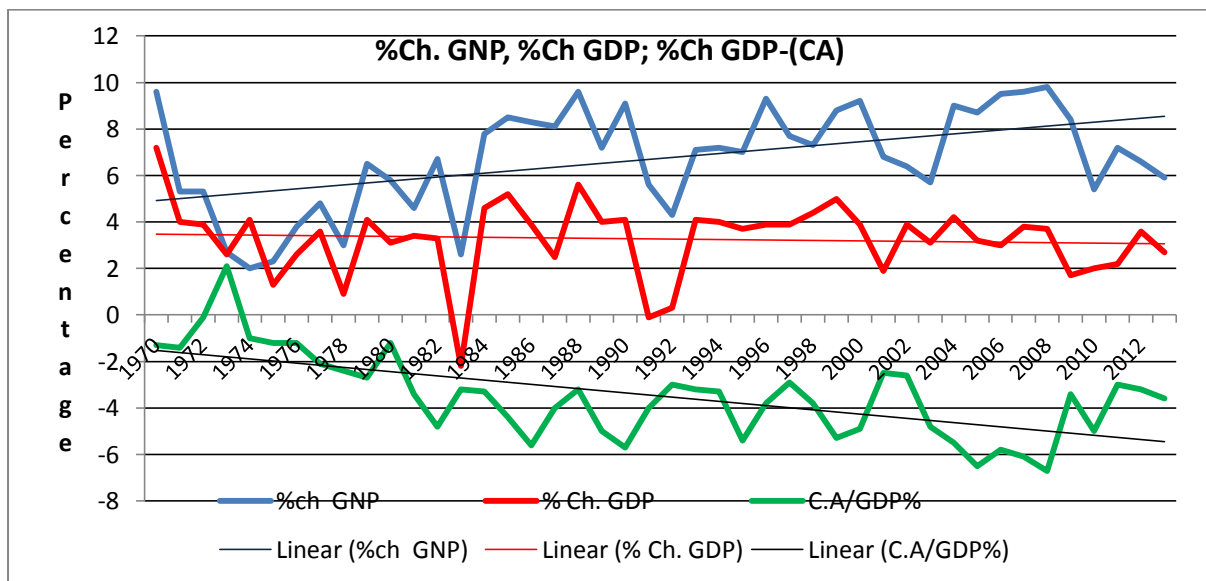
The trade balance is only part of the story of current account balance. The other major component is net income flow which is the difference between the two curves in Graph 13. Net income flow comprises dividends on foreign investment and interest on overseas debt. Net income flow has been in serious decline since 1983. The net income flow is now a policy issue in itself.

The long term current account deficit, is evidence of monetary policy supporting an overvalued currency rather than allow a market devaluation of the \$AUD. This support of currency stability has produced the perverse outcome of a serious net income flow constraint on economic policy. RBA monetary policy has been to administer short term interest rate policy to support an artificially high currency value. To attract necessary capital inflow, policy settings have maintained a positive interest rate differential between Australian official interest rates and international official interest rates. This has suited the RBA in managing its domestic price stability target. However, export industries have been disadvantaged. Over the long term export industries both in manufacturing and agriculture have lost profitability.

In Graph 14 below, the policy problem is set out as the impost upon GNP. The domestic economic growth implications of long term dependence upon capital inflow can be inferred for: domestic investment, employment and living standards. In Graph 14, the current account deficit has been added back to gross domestic product (GDP) to produce gross national product (GNP)

20 Ben Rees

Graph 14



Compiled from: ABARES commodity statistics 2013, Table 6 ,and Table 7

No nation can continue unmanaged deterioration in its current account balance over the long term as depicted in the graph. This can be demonstrated by the simple proposition that if Australia needs 3% domestic GDP growth, then GNP must grow at 3% plus the current account deficit. Such GNP growth leads to demand overheating, price, and wage increases. The RBA pursuing its inflation target has little option but to raise interest rates hurting domestic investment, export industries, employment, and living standards. Consumers have access to cheap imports; but, at the cost of domestic economic growth, employment, and declining living standards.

“ ‘We cannot attract lending from abroad without later paying interest on the newly borrowed funds. Either we pay interest for a while and then repay the principle, or we pay out interest indefinitely while renewing the debt’

and

‘the larger the capital inflows triggered by a temporary rise in our interest rates, the greater the later interest outflows that contribute to the renewed payments deficits’ ”^{xxvi}

A similar argument can be mounted for Australia's insatiable dependence upon foreign investment. Recapitalizing rural Australia will come at the cost of further deterioration in the net income flow and current account balance.

8 A Necessary Step: Asset Enhancement:

In conjunction with Roosevelt's "new deal" in the US Great Depression years, asset enhancement was used as the model to address the farm debt problem. The same principle was employed again as Brady Bonds in the international debt default of the late 1980's and

early 1990's. The model modified once again came to the rescue in the aftermath of the 2007-08 GFC. The US had TARP, the EU used the European Stability Mechanism, Australia endorsed the concept in principle when the AOFM was instructed to intervene directly and purchase residential backed mortgage securities to stabilize the domestic housing debt market; and, consequently domestic home prices. Asset enhancement is a proven model to address a debt crisis and forms the rationale behind the *Australian Rural Reconstruction and Development Board* proposal

The ARDB will be a third Board within the Reserve Bank of Australia. This does two things:

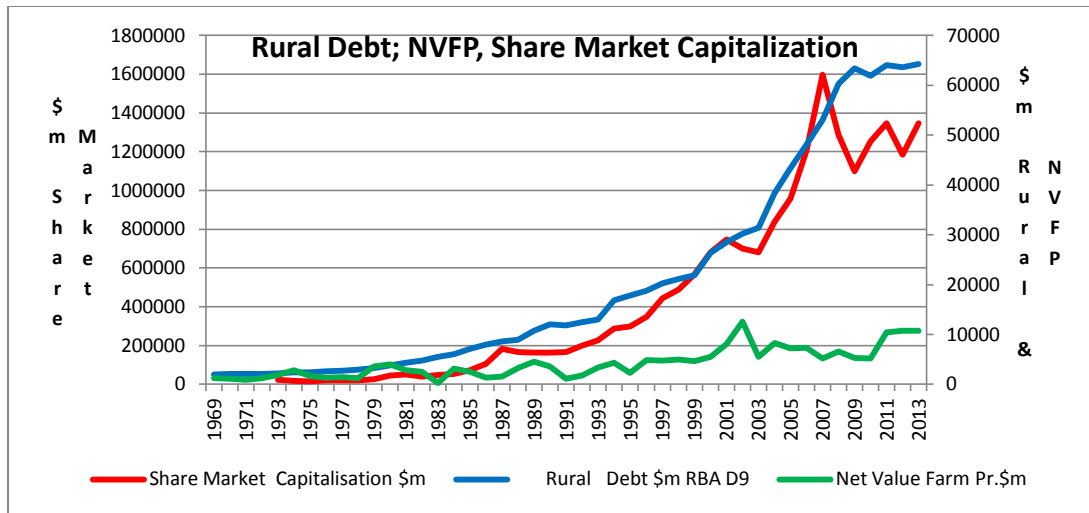
- Formal policy commitment by the Federal Government to establish provision of reconstruction and development finance within the Australian financial system
- Reconstruction and development finance directly supervised by the RBA.

The principle is conceptually simple. A public entity is structured to purchase low quality financial assets from the private financial system at a current market valuation. The current market valuation effectively provides what is commonly called a "haircut" to the nominal value of the mortgages issued in more robust times. The "haircut", provides debt relief to the mortgagor and enhances credit worthiness. The haircut also becomes the penalty of shareholders and their financial institutions that practised imprudent rural lending

Once ownership of the mortgage is transferred from the financial institution to the public entity, the once low quality asset/ mortgage takes on the characteristic of a public security. As such, it can form the basis of an asset pool from which derivative securities can be sold into the capital market thereby generating a self funding program. It is the process of ownership transfer from the retail financier to the public entity where asset enhancement occurs as the low quality asset transforms to a higher quality public sector asset. Interest rates on the mortgage should then reflect the interest rates of government paper as opposed to commercial penalty rates of the private sector.

A second leg of the ARD is the development finance arm. The infrastructure weakness exposed in the recent Graincorp public debate is a typical example of where structured development finance could solve a problem. Another important aspect of the development arm is demonstrated in Graph 14. Since deregulation of the financial sector; and, removal of tariffs and other protective measures, Australia has become dependent upon capital inflow to offset the failure of the ideological Comparative Advantage thesis in international trade. The long term dependence on international printing presses of the large international central banks has change the industrial base of this nation to a point where repayment of interest on debt and dividends flowing offshore to multinationals demands a larger percentage of GNP than remains for domestic distribution to encourage investment, employment, and rising living standards for Australian's.

Conclusions:



Compiled from: ABARES commodity statistics 2013, Table 13 Farm Returns,

RBA Statistics online, Rural Debt Table D9, Table

1. Rural policy failure is encapsulated in this graph. Empirically, rural debt appears closely aligned to asset price movements in the wider community. The capacity to service rural mortgages from farm income appears irrelevant to both financiers and farmers beyond 1983.
2. Since the early 1970's, rural policy has sought to manage the small farm low income problem through a structured program of farm build up. That program has been debt financed and has now transformed into large farm low income debt crisis.
3. The model of Farm finance changed from the early stages of policy from originate to hold banking to originate to distribute. This model shift allowed banks to loan on a debt to equity basis. Government macroeconomic policy supported debt to equity lending by a discretionary policy of asset inflation. The GFC brought this banking model to an abrupt halt. Banks suddenly decided they wanted their mortgages repaid from income. For two decades, farm loans had not been designed to be repaid from income. Suddenly, the farm sector was confronted with: denial of credit, bank foreclosures, and insolvencies.
4. Rural health has deteriorated. Rising levels of depression and rural suicides are unacceptable consequences of changed financial circumstances. The media, politicians and policy advisor are in denial of these problems except to push more counsellors into the field. It is not counselling that is required ; but, sound economic policy

5. As 80% of production comes from 20% of large farmers, the threat to national food production of rural financial collapse is very real.
6. In conjunction with financial restructure, a second step will be required: policy change. That though is properly the consideration of the proposed White Paper.

The RBA Amendment Bill is the basis, and subject of this Inquiry. It is both the necessary and theoretically correct first step in restructuring rural Australia. I commend that Bill to your serious consideration.

ⁱ *Rural Australia V Orthodox Economics* (Bris. 17/10/2012); and, *Rationalize or Reconstruct Australian Agriculture* (Merredin WA 15/4/2013; Colac Vic. 16/4/2013)

ⁱⁱ Edwards G.W. & Watson A.S., *Surveys of Australian Economics*, Agricultural Policy, Ch. 4; Ed. F.H. Gruen; George Allen & Unwin, 1978, Ch. 4, p.192

ⁱⁱⁱ Edwards G.W. & Watson A.S., Agricultural Policy, from, *Surveys of Australian Economics*, Gruen F.H. ed., Allen & Unwin 1978, Ch. 4, p. 195

^{iv} Penguin Macquarie Dictionary of Australian Politics, Penguin Books, 1988, p.181

^v Lloyd P.J, *Surveys of Australian Economics.*, ed. F.H. Gruen, George Allen Unwin, 1978, Ch. 5, p.271-72

^{vi} Watson, A.S. op. cit. p. 274

^{vii} Rural Adjustment, Rural Debt and rural Reconstruction; Report of the Senate Rural and Regional Affairs and Transport Committee, Dec. 1994, p.1

^{viii} Opp.cit p.1

^{ix} Lopez Isidro & Rodriguez Emmanuel; The Spanish Model; New left Review 69, May June 2011, p 10

^x Australian Commodity Statistics 1997 p 219, 206

^{xi} Senate Rural and Regional Affairs and Transport References Committee, *Rural Adjustment, Rural Debt and Rural Reconstruction Report*, Dec. 1994, p.34

^{xii} Ibid, Dec. 2012 and April 2013

^{xiii} Koutsoyiannis A. *Modern Microeconomics*, Macmillan Press, 1977, p.p. 150-155

^{xiv} Davidson F.G & Stewardson B. R.; *Economics and Australian Industry*, Second Edition; Longman Cheshire, 1979, p.229

^{xv} Koutsoyiannis A. *Modern Microeconomics*, Macmillan Press, 1977, p. 163

^{xvi} Paish Matt, Almost half Australia's food industry is owned by foreign investors, report shows, AFN online, Jan. 2012, p.2

^{xvii} Hunter Murray, Who owns corporate Australia?, independentaustralia.net, February, 2013, p.7

^{xviii} Robinson Joan, *Morality and Economics*, Economists View, online, 2007/07, p. 1

^{xix} Robinson Joan, *Morality and Economics*, Economists View, online, 2007/07, p. 1

^{xx} Edwards G.W and Watson As; *Surveys of Australian Economics*, Edited, Gruen F.H, George Allen Unwin, 1978, p. 198-99

^{xxxi} Mansfield Edwin; *Micro-economics Theory & Applications*, W.W. Norton & Company Inc.; 1969, p.p.91-92

^{xxii} Koutsoyiannis A.; *Modern Microeconomics*; Macmillan; 1975, p.49

^{xxiii} Kindleberger and Lindert, *International Economics*, Richard D Irwin, 1978, p.60

^{xxiv} Kindleberger and Lindert, *International Economics*, Richard D Irwin, 1978, p.60

^{xxv} Anker Richard, *Engel's Law Around the World 150 Years Later*, Working paper Series, No.. 247, PERI, University Massachusetts, January 2011, p.35-36

^{xxvi} Kindleberger and Lindert; *International economics*; Richard D Irwin Inc., 1978, p.369