

The ARDB as a catalyst for prudent change in financing Australian Agriculture

Submission to the Senate Economics Legislation Committee Inquiry into the
“Reserve Bank Amendment (Australian Reconstruction and Development Board)” Bill

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Rectifying systemic failures in the financing of Australian Agriculture requires prudent government intervention. Structural defects, market failures and policy oversights have impoverished rural Australia needlessly. Without reserves or realistic possibilities of building them, agricultural enterprises will remain at the mercy of the seasons, speculations and imperfect markets.

No real progress will be made while this supposed “pillar” of the economy retains significant weaknesses by design. The Australian Reconstruction and Development Board is tasked and organised to help resolve common financial challenges effectively, equitably and efficiently. Sectoral reconstruction and revitalisation are needed, not continuance of perspectives and practices that fostered poor decision-making, illiquidity and limited development. Analyses of significant challenges and of the ARDB as an apt response are presented in this submission and attachments.

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RATIONALE

This Bill has been proposed because:

- R.1. Market failures have occurred in the financing of enterprises across rural Australia.
- R.2. Underlying this are systemic flaws and deep structural defects.
- R.3. Prudent public intervention is then needed.
- R.4. An ongoing capability to remedy and avoid such failures and defects best resides in the financial system and connected markets.
- R.5. This capability is needed quickly due to rising rural illiquidity and rapid deteriorations in the current and capital positions of significant enterprises.
- R.6. Amending the Reserve Bank Act to establish a Board with facilitation, reconstruction and development responsibilities offers an optimal solution.
- R.7. Rectifying sectoral illiquidity, systemic failures and structural defects will improve financial products, asset markets and incomes.

The ARDB would, directly and through other parties, assist in remediating failures and defects that undercut the financial sustainability of Agriculture and associated industries.

ILLIQUIDITY

Farm funding has become very difficult for many in the last year. The use of standard mortgages primed the current illiquidity in farm financing. Debt funding grew rapidly since 2000 despite obvious misfits between

- mortgages that *by design* assume stable incomes and changing production and market realities;
- a rising disconnect between incomes and servicing obligations;
- expected and actually realized performances.

A suite of mortgages became evidently subprime in 2013. A mix of high interest rates, drought impacts, public policy stances, commercial price setting actions and asset revaluations were triggers. Most obviously affected were the pastoral lands of Northern Australia, the Eastern wheat belt of Western Australia and dairying in parts of South Eastern Australia. In these areas finance became difficult to obtain and expensive while farm sales slowed or stalled even as prices moved well below previous values in a number of districts.

The overall rural financial condition (RFC) is difficult to determine empirically due to the withholding or limited analysis of data. For example in 2013, the relevant banks refused to supply information to QRAA for its annual survey and ABARES most recent farm survey does not include estimates of “capital appreciation” contributions.

Specific features can be determined from the reports of accountants. For example, Deloitte's concerned commentaries about asset to income ratios rising from 5:1 to a 9:1 peak, then back to 8:1 (and I would expect now lower). Talk is of farm prices falling 30 to 70+ per cent but I leave this for others to address. Attachment 6 provides an empirical illustration of how even farms that meet all commitments can be caught as equity (or LVRs) fall across a sector.

CRISIS

Asset inflation followed by deflation is part of Fisher's debt:deflation model of crisis, a development of which is provided in Attachments 4 (slide 25) and 6.

A crisis is triggered by income problems and changes in valuations leading to spreading concerns about equity levels (security) and repayment prospects (servicing). When security concerns dominate loans may be, and reportedly have been, unilaterally terminated by financiers even when servicing is fully up to date.

Contagion becomes a real risk as falling asset values affect all farms, even those with no debt. Liquidity dries up until the down slide is seen as complete only after the property overhang is liquidated.

Markets typically overreact, with needless loss of wealth. With active assets, such as farms, capacity is also destroyed. Serious new entrants, having delayed until both prices had bottomed and income:asset ratios rectified, now face considerable restoration costs. A once productive farm becomes derelict if restoration is too difficult or expensive, not for production, environmental or like reasons but due to a fatal financial exposure.

Such is the process. An extraordinary cycle has been playing out around the world over the last two decades: funds from three great credit waves flowed into assets that became increasingly overvalued before a correction was triggered with downslide instability to continue until asset values *are seen to* better reflect realizable earnings.

Clearly, a key consideration by the Committee is whether these are "normal" times in rural Australia or not. In the 17 months since the Rural Finance Roundtable was called, it has become increasingly evident to me that these are abnormal times and that a crisis is underway, with collapse a possibility in some regions. Even if times were supposed "normal" the situation of Agriculture and associates across the nation is far from one of pervasive, robust good health.

TRANSITION

When complex systems collapse, change is abrupt and unexpected. Transitions will become more chaotic as transactions become more difficult and uncertain. While some major losses have occurred and will occur, there is still some time to transit rural Australia in a reasonably effective, equitable and efficient (E3) manner.

The alternative hypothesis is, of course, business as usual. These are then only "slightly away from the old normal" times. Such a belief has driven responses globally for the past "hot" 6 years of crisis and the longer "cold" build-up phase. Yet recovery remains "fragile" and, perhaps, illusory as interlinked banking, default and currency crises play havoc with the real economy and the lives of people.

Fortunately it is now realized that there are significant problems in at least some parts of rural Australia and some systemic issues in financing. Additionally, looking forward there are major aspirations to make Agriculture an enhanced contributor to Australia's prosperity and, indeed, a pillar of the economy.

Unfortunately the pillar is currently suspect, something that I would expect most to agree to. Further, in all the many and lengthy “food bowl to Asia” and like documents there has been the same omission: agricultural production and farmers are assumed. Yet real farm returns have been trending down since the 1950s. There is a major disconnect between run-down rural realities (even without a crisis) and the rhetoric of food supply chain nirvana.

This is most glaring in the financial dreams of a trillion dollars or so of postulated investment to be happily provided via benevolent foreign investors in an ultimate morphing of a cargo cult mentality. It is time to move past such unfounded speculation. The future and agriculture are too important.

DEVELOPMENT

A capacity to develop involves having available funds that match the realities involved. Misunderstanding the realities dissipates and wastes funds and other key Capitals, while a scarcity of Capitals limits feasible activities and competitiveness. Prudent capital formation has been inhibited by a generation of high real interest rates that saw what “normally” would accrue as capital allocated as current incomes.

Conventionally today, “The State” or “The Market” is seen as both starting point and potential “saviour”. However, just as the solvency of the State limits the Keynesian stimulus in theory and practice, so also differences in the Circulations of Capitals limit any Competitive Market options (for Friedman, Hayek, Walras and others).

It is not funds or other Capitals *per se* nor circulation *ex situ* but rather effective combinations and yields over times and places that matter. Crises arise when imbalances make obligations unmeetable. Capitals dissipate and de-connect. So it is with Agriculture and associated Industries in Australia today.

Half a century of capital rundown (and returns transfers) has now reached its limit. The Capitals of Agriculture need revitalization if they and it are to have a future. We need a cogent national narrative on the economics and finance of Production in Agriculture today and for tomorrow. We can no longer simply “assume production”.

Essentially, we failed to adapt our thinking, strategies and practices as the world changed. Financial arrangements from times now long gone remained. For example, time-critical mortgages that worked reasonably when commodity prices were long-term contracted and trade limited are ill-suited to a world of MNEs transacting differentiated products across heavily managed markets.

Oversimplifying, talking Porter (“competitive advantage”) while thinking Ricardo (“comparative advantage”) and little else sees confused strategies domestically and externally. These later issues are properly matters for an incisive White Paper. Our concern is with financial issues needing more immediate attention.

THE AUSTRALIAN RECONSTRUCTION AND DEVELOPMENT BOARD

An Australian Reconstruction and Development Board (ARDB) within the Reserve Bank of Australia (RBA) would be established by the passing of the legislation currently under review by the Senate Economics Legislation Committee.

The central intent is to improve the decisions, performance, development and capital positions of enterprises in Agriculture and associated industries by resolving, as far as possible, systemic failures and recurrent financial problems within the financial system. Welfare would remain a Commonwealth responsibility. Many other aspects can be better solved within an improved finance system.

When established, the Board will decide strategies and actions given its Charter and evident or emerging financial needs. It may act directly, through various agents and with existing organisations. Policies, strategies, actions and their impacts will be open to:

- regular formal review, including within the RBA., through Parliament and the government of the day; and
- ongoing engagement with key industry stakeholders; and
- approaches associated with mounting or untenable financial stresses.

ARDB TASKS

Some of the actions the ARDB could undertake through appropriate organisational arrangements include:

facilitative tasks, to aid better financial decision making by businesses, including *via*

- ongoing monitoring of financial arrangements, economic arguments and stresses in Agricultural enterprises and regions;
- identifying potentially destructive changes in the financial environment;
- use of good financial practice case studies and guidelines;
- fostering the development of new financial arrangements that better recognise the production and market realities faced, and associated risks.

reconstruction tasks, to assist needed financial transitions, including those associated with

- mitigation of rising financial stresses;
- stabilisation of land prices so as to better reflect income potential;
- termination of no longer tenable financial arrangements;
- bridging arrangements when illiquidity is high; and
- intergenerational transfer of farm assets.

development tasks, to help ensure that needed development funds are offered from appropriate sources in ways that support capital formation and reduce needless financial risks associated with the operation and development of farms and select associated enterprise. Traditional areas that might be considered include: land and other property development; plant and equipment efficiencies; farm production sustainability; and produce management systems. Such considerations would ideally be drawn together in effective “investment project” financial agreements that were medium term (10 years with joint reviews and extension options say) and less time-path critical.

The financing of Australian Agriculture remains dominated by increasingly dated and inadequate financial arrangements. The world has changed. The ARDB can assist more prudent investment arrangements that better accommodate current, and emerging, production and market realities. Helping existing enterprises and organisations to thrive while addressing systemic weaknesses is the ultimate goal.

These are some of the possibilities. It remains for the Parliament to legislate and then for the Board to decide specific needs, priorities, details and strategies

FUNDING BASIS

The actual basis of funding is for the Board to determine with due prudence. There appear to be several good options but I am not a banker. More importantly, the optimal option will vary with the nature and extent of market or systemic failures, procedural defects and product faults. Ideas presented are for discussion and development as may be appropriate.

If serious illiquidity is present, the ARDB acting as part of Australia's central bank can offer a Standing Facility, Special Purpose Vehicle, direct funding packages or such arrangements as may be prudent in the Bank's opinion. The RBA is a bank after all. It is best placed to arrange funding in any serious liquidity crisis, and would typically engage appropriate external expertise (such as QRAA, farm accountants, rural banking specialists or sectoral analysts).

In more normal times, the goal would be to complement parties within the financial system offering funds incorporated in improved, robust, de-risked and more prudent arrangements. Better financial products are needed, and the ARDB can be a stimulus, organiser and funder as may be appropriate.

Setting the ARDB within the RBA and financial system fosters microprudential thinking and actions. Major moral hazard problems arising when Governments effectively underwrite finance would be reduced.

RECONSTRUCTION

Importantly, title to "freed up" real assets would be taken on – not the debt. Inflated or risky securities would not be accepted, including for example CDOs (as is the current RBA position). Previous financial package would be dissolved through separate, appropriately E3 processes with an ARDB framework indicating expectations for "real asset take-on".

As an example at the property level, a now \$5m loan (including penalty interest, arrears and the like) may *or should* have been built around "real farm property" now valued at \$1.5m on a "five times income" (5Y) basis. A "5Y" offer for the real assets would be \$1.5m in exchange for real property titles. Income estimates would be built on good practice (such as "Year In – Year Out" analysis and the like). Obviously, "5" may also need prudent variation.

At the industry level then, if there were around \$5b in distressed agricultural loans, direct funding needs centre around \$1.5b. Actuals would range with circumstance, most obviously the actual distribution and state of "frozen" assets, something that this Senate Inquiry will

make clearer I expect. Obviously, and given its access within the financial system, the ARDB could make much more adequate estimates and develop strategies in consultation.

Obviously also, parties may seek other offers but if there were none the property could be effectively held off market until “normal” conditions resume in the farm land market while the farm asset is maintained in operational condition.

QIDC did this, realising a considerable profit on its operations. A key difference, though, is that here the government budget and its debt position are not affected (as is the case with “rural adjustment” programs and past “crisis” holdings of various real estate securities, typically at a full, “perhaps optimistic” value). The RBA or an agent can act as a bank in its own right carrying conservatively valued real assets as security against funds advanced.

CONSIDERATIONS IN FINANCE DESIGN

Variations could allow the inclusion of “Special” (S) considerations in a “5Y + S” model. No property exists in isolation, such as those on an urban fringe, with high natural amenity or in a run down condition. “S” allows partitioning of an aggregate value and separate treatment of its constituent elements. Appropriate setting of interest rates and identification of real capital improvements (as distinct from cyclical or speculative movements) could be accommodated. Real development impacts could be distinguished from windfall changes.

A key trade-off in packaging is between asset valuation and interest rate expectations.

- The same income can service a higher asset value at a lower interest rate.
- The higher the expected interest rate, the greater the asset write-down.
- The greater the potential variability and range of interest rates, the lower the prudent “take-on” value or asset strike price.
- The more intense the time-sensitivity the higher the risk associated with income fluctuations.

Finance package design and detailing will need to accommodate such things. A “pooled capitals” model or “joint venturing” approach may be much more suitable than the current “pay on schedule” contract.

Funds and other capitals may be selectively sourced domestically or externally but a major recent problem has been overbidding by foreign investors who have access to low interest funds and high value “S” considerations. Recall, for example, the Global Farmland Rush that included panic buying in 2008 after a rising global food shortage. Seeking security, three dozen nations imposed export controls on foods as prices rose well above expectations.

Today’s “failing finance” is based on assumptions of income regularity and certainty. But, if we know anything about farming, it is that incomes are highly irregular and uncertain at the individual, district and often regional levels. With the rushed removal of ECIRS and other safety net provisions, exposure is complete and loan risk rises immediately. Compounding problems is the continuing use by financiers of short-term borrowings to fund long-term commitments. Automatic AUD funding roll over at attractive rates is a risky assumption.

While volatility at establishment level may be great, industry-wide averages may be more stable. As a member of the Queensland Sugar Board once commented, cane and mill districts vary a lot year to year but along 1200 miles of coast things tend to average and we can sell with confidence. It is time to recognise more fully the implications of the differentiated yet continental nature of Australian Agricultural production, the various interplays between regions and how these might be used to advantage.

DEVELOPMENT FINANCE

Australia is not likely on current trends to be a food bowl to anyone. For example, in the much hyped milk sector, production values are falling. Current returns are an inadequate basis for the existing industry with some “interesting” perverse outcomes (as when milk prices were rising in New Zealand due to then high export prices while in Australia “down, down” price setting went effectively unchallenged).

Clearly it is not just financial arrangements that need attention, but finance that promotes sensible long-term development is an ARDB focus. Ideally, term funding arrangements would align and sharing of the returns from capital formation and enhancement would be seen as a preferred alternative to “routine” interest withdrawals for some types of projects.

Development bank operations could be modelled on previous Australian successes as well as the industrial banking approach used successfully in Germanic Europe. Successful development banks are evident in many nations, but not in Australia currently. We need to develop our own “good practice” model.

Key features of such a model would include realistic recognition of:

- start up costs and the time lag before revenues build sufficiently for ongoing profitability. Hopevale bananas provide an interesting example of the challenges that need to be overcome in new developments, and profits there are not expected until 2016 all going well.
- the trade offs between holding “just in case” reserves (for drought or other natural disasters) and reducing debts or accelerating capital development.
- the investment costs of physical drought proofing, environmental restoral and other good stewardship actions.
- the uncertainties and increased financial risks associated with servicing international markets.
- the impacts of competing imports on enterprise returns, and how these might be countered or mitigated.

Australians in the past pioneered “fit for purpose” technologies that underpinned industry advances and rural achievement. Today, financial and other business technologies need to be made fit for the various purposes that will again advance agriculture in Australia.

SUPPORTING DOCUMENTS

A number of documents have been developed during the development of this proposal and most have been separately provided to the Committee. They have also been posted on ruraloz.net , a site especially created as an easy reference for my materials in this area.

The documents include:

- A briefing note on the broader initiative and the envisaged role of the ARDB [1]
- A paper arguing the need for changed positioning of rural Australia [2]
- A research note outlining recapitalisation issues in an open economy [3]
- Powerpoint slides used to outline key issues and problems [4]
- A perhaps tongue-in-cheek single sheet reconciling the ARDB proposal with statements from leading politicians [5]
- A paper consolidating aspects of the research, including empirical and schematic explorations of the current rural finance condition [6]
- A paper relating enterprise viability and food security in an open economy [7]

These should be seen as attachments to this submission. Clearly I am happy to expand on any aspects as may be appropriate.

SOME CONCLUDING COMMENTS

Deep structural defects and systemic failures have brought rural Australia to its present mixed and too often sorry state. Just tweaking past thinking and practices will achieve nothing as the foundational problems will go unaddressed, especially in finance.

Interdependencies matter. De-risking some (contagious) enterprises derisks whole sectors. While some gain directly through reconstruction, all gain from reduced sectoral risk and lower financing costs. This is a key challenge in improving the current rural financial condition. Situations are mixed with some doing well but, in aggregate, performance is clearly declining.

Galbraith in his last book talked of “innocent fraud”, and such a fraud has visited those in the country. It was not a deliberate desire to impoverish, but that was too often the outcome. An extraordinary cycle built as “bad” investments were made and reserves ran down. With hindsight we can see mistakes and problems on all sides.

The real choice is whether to remain chained and constrained by cycles of increasingly failing financial arrangements or to resolve the past as best we can and prudently reposition ourselves for future opportunities and challenges.

To revitalise Agriculture and associated industries in Australia we need a circuit breaker to halt sectoral downslide, realistic opportunities for “enterprising capitals” and a renewed spirit. Perceptual problems underpinning systemic failures need to be remedied.

A well-constituted ARDB can help rebuild rural prosperity and improve the wellbeing of all Australians. Such are the opportunities present in this Bill.

ATTACHMENTS

1. McGovern, M. and R. Walton, *Tailored Funding Initiative for Agriculture (TFI Ag) Briefing Note* An Initiative to Rectify a major internal funding problem within Australian Agriculture, 2013(Rural Finance Roundtable Working Group).
2. McGovern, M. "Repositioning Rural Australia" in Choices in Agricultural Policy: Rationalise or Reconstruct? 2013. Merredin WA: Muntadgin Profit Farmers.
3. McGovern, M. "Recapitalising in an Open Era" in Some preliminary research findings and comments for the "Graziers Crisis Meeting". 2013. Richmond Qld.
4. McGovern, M. "Revitalising Rural Australia (Powerpoint)" in Rural crisis meeting. 2014. St George.
5. McGovern, M., *ARDB Compliance with some policy positions* 2014.
6. McGovern, M., *We live in Extraordinary Times*. 2014 forthcoming
7. McGovern, M. *Food "security" and enterprise viability*. in *PBFEAM*. 2008. Brisbane: QUT.

All are available at ruroz.net and can be alternately provided upon request.

THE AUTHOR

Dr Mark McGovern is a senior lecturer in the School of Economics and Finance at the Queensland University of Technology. He has studied widely with degrees in Science and Economics, a Masters in Regional Science and an innovative doctorate investigating economic activity and impacts. Published papers and reports range from industry, trade and regional analysis through infrastructure planning and public private partnerships to public finance and soft computing.

Mark has a long-standing and active research interest in Agriculture, rural Australia and regional development. Industries researched include sugar, beef, pigmeats, tourism, hazardous wastes and construction with topics ranging across industry impacts, infrastructure funding, regional change, economic development, international trade, international business and collective unintelligence.

At QUT Mark has lectured in all areas of Economics including Industry Analysis and, currently, International Economics. He also lectures in International Business units, currently in Finance for International Business. Supervised doctoral students have researched regional development frameworks, principal-agent problems, infrastructure evaluation, monetary policy frameworks and agriculture in open economies. Mark is an active contributor to policy debates and emphasises the need for greater understanding and constructive engagement. He can be contacted at m.mcGovern@qut.edu.au