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Subprime agriculture, and Australia?[☆]



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ABSTRACT

Today, Australian agriculture is not where we hoped it would be. Despite being highly productive and the nation's only 'strongly competitive industry', it is struggling across the country. There are successes, as there always will be, but the bulk of our food and fibre production is from enterprises with minimal profitability and unstable or unsound finances. A debt-deflation spiral and subprime mortgage crisis are now being fuelled by property fire sales while leading bankers proclaim no problem and governments dance at the edges. However, it is not just the bush that has problems. National economic conditions are deteriorating with per capita incomes falling and real interest rates still high. Well-informed policy strategies and effective responses are needed quickly if Australians are to avoid needless losses of capacity and wealth destruction in the cities and the bush.

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1. Introduction

Australia is currently not at its best with evidence of serious societal stresses. Financial anxieties and economic uncertainties abound across the country. While problems are increasingly evident in the cities, they are acute in much of the bush. Here a subprime crisis has been unfolding. Little response has been evident, as occurred in the early days of similar events in the USA and elsewhere. Those affected are little regarded in the halls of power, academe or commerce.

While Garnaut (2013) has recognised our coming difficult "dog days", Mackay (2013, and earlier) our increasing alienation and others such as Argus (2013) have provided further exceptional insights into our national situation, it seems we still lack engaged understanding and leadership to tailor adequate responses to growing challenges. So instead of rectifying problems we avoid them. Worse, the inertia, hubris and alienation attributed to lemmings seem to be dominating Australia's collective thinking processes.

Discontent and disconnects are increasingly evident in the population, as seen with the first 'Liberal National' Budget strategy and the comprehensive opposition by the population. This divide reflects the first serious policy rejection for decades. In the bush, however, things are even more peculiar with the nation's only "strongly competitive industry" in deep trouble. However, bankers, many industry leaders and others repeatedly deny problems while farm foreclosures rise rapidly and farm prices fall disastrously. As they send in the liquidators, banks improperly withhold important, previously available information despite repeated requests from Ministers and others.

You might react that "this is just the way of the world" but these are exceptional times. Systemic flaws and shared irresponsibilities underwrote the distressed loans that are the core of problems in Agriculture, and elsewhere. Farmers and

[☆] All web references were most recently accessed between August 2nd and September 9th 2014.

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bankers combined with government and other agents to generate financial arrangements that were destined to fail country-wide. Market failures and natural disasters (Hughes, 2014; Neales, 2013, amongst many) have revealed the rot in our joint financial creations, and the inadequacies in our responses to date.

While solutions are available and some dialogues are occurring, progress is painfully slow. The will to act is so far lacking. So, needlessly destructive fire-sales burn ever wider, destroying important economic capacities and national wealth. Australians, all, deserve better.

“The G20 meetings over the next twelve months must be a reminder to all Australians that unless we prepare for the worst of economic times when we can, then the pain during recovery will always be far greater.” Hockey (2014).

Australia did not prepare at all for the worst of economic times in the bush (Section 2). Responses and policy thinking have been inadequate, but good options are available (Section 3). Now the subprime malaise is spreading. Incomes and prices are falling nationally while interest rates and the dollar remain very high (Section 4). The pain and costs become greater and more widespread the longer we linger, so it is time to act (Section 5).

2. Down, on the farm¹

Agriculture is a stand out success according to some, but its businesses large and small are failing. This paradox has built from a preoccupation with ideas and measures that have limited direct relevance. Problems build unnoticed when irrelevant analysis crowds out direct insights.

2.1. Paradox, and resolution

Agriculture is Australia's only “strongly competitive industry” (Business Council of Australia, 2014; McKinsey & Company, 2014). Yet, the industry is today characterised by high levels of debt,² low farm income, depleted reserves, increasing levels of insolvency and rising poverty. Why the mismatch?

Productivity is high in agriculture. Indeed productivity performance has been outstanding. Yet profits and incomes have been miserable for years. Situations vary across the nation with, for example: Queensland farm incomes the lowest since at least the 1970s; Victorian milk incomes and production down markedly since retailers exercised unbridled market power; and Grain growers in Western Australia refused planting finance for the first time since the Great Depression. Still governments and most industry bodies refuse to act.

Australian Agriculture has for two years been suffering under a text-book subprime mortgage crisis. Debt arrangements failed as incomes and land values fell. Halting a debt-deflation spiral is tricky but actually reasonably easily attainable in Australian Agriculture should we so choose.

Stabilisation is the first challenge. Denials need to cease. Serious individual and systemic problems need rectification. Some new approaches are needed as there is much to learn from the misfortunes and successes of others since 2007 and relevant ‘renewed thought’ in economics. Flawed analysis needs particular attention.

2.2. We are using and measuring the wrong things

Productivity and competitiveness have been central concepts in Australian policies for decades. However, measures of both competitiveness and productivity can increase when an industry is in decline. They then transmit perverse signals. Analysis so based hides problems that then go unnoticed and unaddressed. Those ‘with the analysis’ routinely rebuff the protestations of those directly affected in a cruel parody of reasoning.

Existing policies and thinking have not delivered gains for Agriculture in real terms (as evident in Fig. 1) or Australia (as in our deteriorating food trade balances). Continuing them is folly.

Disappointingly, the same failed conceptual stance sits behind the “new” veneer in “Building Australia's Comparative Advantage” (Business Council of Australia, 2014). Under its dated take on comparative advantage, economies of scale still rule. Ignoring the last century of international trade theory and the monopoly tendencies innate in unchecked economies of scale (Robinson, 1969), the authors seek to reinforce a view that has dominated Australian industry since the 1970s.

Reviewing the reports, a productivity mantra is repeated regularly but profit is never mentioned by the BCA, and incidentally mentioned only twice by McKinsey. Yet profit and sustainable incomes lie at the heart of sound business, investment servicing and capital formation.

¹ Some parts of this section have previously online appeared in McGovern (2014).

² Problems appear concentrated in full-time specialist farms, especially in some regions and sectors. Around half of farmers apparently carry no debt (often due to off-farm incomes) and would have full equity (presuming no other financial obligations). They may have unrecorded ‘non debt’ financing arrangements. Their share of agricultural production is unknown. Beyond urban fringe areas, they are exposed to falling asset values and potential costs could be high (especially if the farm is used as security in another venture or a joint venture). Adequate data is not available. Thus, decision makers are uninformed with attendant market failures not only likely but increasingly evident.

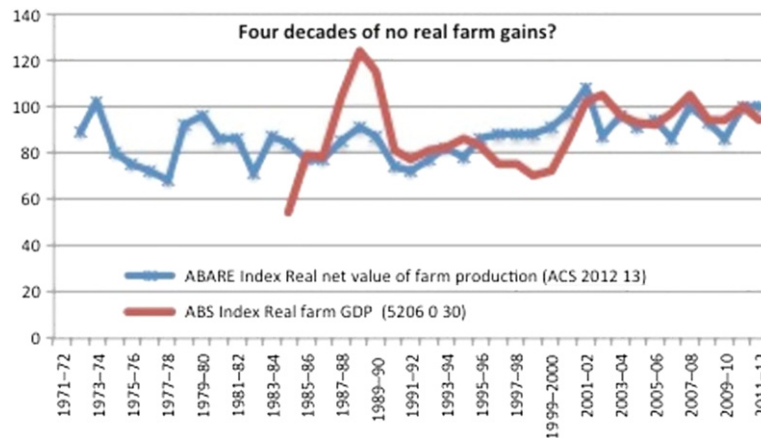


Fig. 1. A rocky path to nowhere but trouble?.

Source: McGovern (2013c).

Australians have been ill-served by such expositions of competition and productivity. The concepts are valuable but they are neither sufficient nor necessarily consistently informative. They are properly used a part of a multi-attribute analysis, not as sole signifiers of purported successes. Two examples, from the lecture room and farm, demonstrate the types of problems that can arise from uncritical use.

- Around the world, business and economics students receive the mantra that the profit maximising firm will produce at an output where “marginal revenue equals marginal cost provided price is above average variable cost”. A loss is made if price is below average cost, *but who links persistence of such a price to rising debts—or the competitiveness implications of debt, equity or sovereign funding?* Such things distort competitiveness and fuel crises if losses become synchronised³ and some funding methods are privileged over others. Such issues appear to be never discussed, so lecture room convenience perpetuates deeply flawed thinking about enterprises in markets.
- In severe drought, breeding stock will also be sold elevating apparent incomes received. Productivity measured rises, but it is miserable on farm. After rain, herd rebuilding takes livestock, time and funds. Revenue and productivity fall, for years, while capital reformation occur. Still expenses continue, including debt servicing which becomes more difficult when financiers unilaterally attach risk premiums and other measures that enervate enterprise. Productivity measures issue perverse and incomplete signals.

Overreliance and uncritical use of a few preferred measures can blind analysts to building stresses, or a developing crisis. Such things suffice until the damage done is recognised ‘all the way to the top’. Even then, paralysis and denial can be expected as managers avoid real change.

2.3. Policies incubating crisis

It is 1997 thinking. Then, the Minister for Primary Industries John Anderson convened a Rural Finance Summit in Canberra. The thrust was similar to today. Scale was the saviour and the message was that over a quarter of farmers must go. We overachieved—more than 40% or 103,000 farmers went during the nine-year Howard-Anderson era (McGovern, 2013c). Such is the effect of oft-repeated economic mantra and bankers with open loans books chasing market share.

The reality is economies of scale⁴ require enterprises to increase operational size, invest in the latest technology (such as limited till farming and GPS navigation), employ advanced managerial systems and so on. Increased farm size increases capital intensity (as with fixed costs of larger machinery and equipment items). All these required funding, yet financial considerations were and remain essentially absent from policy and even industry discussions. Reports abound of minimally analysed loans, but understanding of actual situations and practices awaits a Senate or other responsible Inquiry.

Farm sector reforms have now created a sector with 20% of farmers producing around 80% of output from an increasingly untenable financial basis. Neglecting aggregation costs has been fatal for borrowers, suppliers, lenders and the wider

³ Synchronisation occurred in the lead up to the onset of the Global Financial Crisis. Central banks coordinated interest rates, three very large waves of monetary growth emanated from the USA and financiers globally actively pursued similar business strategies. Such synchronisations were later complemented in Australia by the abrupt removal of farm loan interest support.

⁴ Properly we are discussing economies of size but we follow the current practice of not differentiating these from those of scale. Such economics can be important but the associated costs and risks need to be practically and financially manageable. Farmers who expand in a rising market for assets are particularly exposed, as many are now unfortunately discovering.

community. While individually focused, such costs impact systemically.⁵ They threaten loan book stability when sufficiently large and concentrated in time.⁶

2.4. Loans, designed to fail?

As asset inflation was thought never to end and available funds were abundant, many issued loans⁷ *were not designed to be repaid* from income. Capital gains would pick up any shortfall. Analysis was advised on such a basis (Carroll, 2010, 2011). Then, as stresses built, risks rose and the GFC unfolded with pervasive capital losses, support for economies of scale arguments and previous lending practices collapsed.

Contracts evaluated and agreed under prior conditions were now to be differently serviced. Misspecifications went unaddressed. Problems built apace. Unannounced, unilateral revisions of loan-to-valuation ratios ushered in a financial crisis in national food production. Large highly mechanised “efficient” enterprises were suddenly required to repay multi-million dollar debts from insufficient income.

Foreign buyers opportunistically acquired most significant Australian food manufacturers and around 12.5% of farmlands (Gray, 2014; Thompson, 2013). Crowding out of potential local purchasers by foreign purchasers with more competitive funding sources occurred. Apologetic statements that Australia “has always depended on foreign investment”,⁸ a “policy space” in international trade and investment agreements⁹ and needless delays by the States in differentiating land purchases saw an uninformed market. Some banks and governments appear to have effectively acted as brokers for foreign interests but actual determination of situations awaits suitably updated land registers and an appropriate public Inquiry.

Motivations for purchases are unknown since the FIRB and States provide minimal information. Neither a business case nor a substantial mutual impact statement is expected. Where purchases allowed vertical integration we can routinely expect transfer pricing, manipulable channels and in house-arrangements to capture potential rents and other sources of advantage. Domestic vertical integration allows market bypass and potentially anti-competitive behaviours. Unchecked international vertical integration often results in the ongoing losses characteristically experienced by organisations and nations that uncritically preference assets sales ahead of debt restructuring and servicing. The G20 agenda on international transfer pricing and the like indicates the seriousness of the problem.

Domestic aggregations of farms present their own issues. The potential success of a farmer with good equity in a property purchasing a bankrupted neighbour will depend on the price paid and how this price impacts on equity calculations by the financier. A buyer with full ownership of an existing property can even undercut their own position if the “bargain price” is then used to guide valuations of both properties.

For example, a buyer with full equity borrowing the full price of an identical property is immediately at 50% equity if the financier values the original farm at the latest price.¹⁰ Information on valuation trends and the possibilities of such risks should be publicly available if well-informed purchases are to be made.

When markets are erratic or falling heavily with unusually high volumes of sales, any bargain buy has the potential to reduce valuations across the district or region. Loan valuation ratios (LVRs) can easily then rise to levels unacceptable by bankers concerned about security ratios. This is the classic contagion effect.

2.5. Liquidity in spiralling markets

Liquidity disappears as genuine buyers hold off and lenders avoid this risky sector, leaving the bankrupted farmer stuck on the farm or in another limbo. As one Western Australian put it, “*I now know there is something worse than losing the farm. That's being stuck there for over two years with no one wanting it, and watching it fall apart around you*”.

⁵ Failure of just ten percent of loans can be more than enough to bring down a banking system when conditions are ‘right’. Agricultural loans totalling \$70b are far less than this level so we are not talking about general systems failures. However, specific system failures are evident.

⁶ In more normal times few loan failures occur together. Today regional circumstances, contagion, synchronisation (including *via* policy resets) and vintage alignment have focused risks markedly for the ‘farm book’. A financial system can fail to service a sector on sensible (or sometimes any) conditions as banks or other agencies become reluctant to lend for farms until foundational issues are fixed with the sector de-risked.

⁷ Asset–liability lending became popular in the 1990s as loans were structured with a view that a lender’s liability could be safely raised if the asset used as collateral was of a comparable value. Insurance and ‘sophisticated’ risk management strategies were held to provide sufficient surety. For the financier, interest then became a return on ‘an asset’ (the loan). Contingencies in income streams were ignored, or assumed away. Such loans could be bundled and sold as ‘fixed income’ securities, or held as ‘reliable’ income streams. There need be no intent to pay a loan off. Indeed, full repayment would destroy ‘the financial asset’ and ‘ongoing’ income streams from it.

⁸ Australia has long allowed foreign investment but still funds much domestically. Foreign investors have experience mixed success, and their impacts on Australia have varied. Australia’s strongest growth period was after Federation when there was a net foreign investment *outflow*.

⁹ A “policy space” was agreed as regard foreign direct investment in Australian farmlands as part of the 2014 South Korea–Australia Preferential Trade Agreement. Similar arrangements may well be part of the PTA with China scheduled for completion in late 2014. Australians overwhelmingly favour a cessation of foreign direct investments in Australian farmland and much tighter controls are stated government policy. However, maintaining this window of ambiguity allows ongoing farmland purchases under virtually no conditions by foreign investors. Some purchases have occurred but the extent of take up is unknown because the States have delayed adding a suitable field to their land ownership databases for several years.

¹⁰ This is the ‘mark to market’ problem familiar from US and other ‘falling land market’ experiences. What works sweetly in a rising market will drive a falling market ever harder downwards. Suitably disaggregated time series data can help but the problem stems from using the most recent (marginal) purchases as an (average) valuation for all like properties purchased.

Essentially, the ratios that brokered rapid amalgamations of properties when prices were rising work in reverse as prices fall, with an extra sting once penalty interest rates and the like are imposed. Genuine ‘farming’ buyers will be reluctant to enter the market while such serious risks and the prospect of further price falls persist.

“A number of submissions pointed to the trap of high default interest rates. [An earlier witness involved in a failed commercial loan] Mr. Sean Butler pointed out his default interest rate with Bankwest was 18.81% if not repaid as agreed. Where people are in financial trouble and miss repayments, the default interest rate can be too large a burden to overcome and the business or investment is doomed. Whilst the bank is entitled to retrieve its principal and interest, the excessive penalty interest rate is of concern. It was put to Bankwest in the inquiry that the higher penalty rates may in fact lead to a huge tax saving for the bank...” (Senator Williams, 2012).

The tax deductibility of the magnified loss was confirmed by the Bankwest Witness, Mr. De Luca, as were a number of other ‘doubtful practices’ including opportunistic sales well below the offers of competing buyers.

There has been no real rectification of such issues since 2012. Banking and regulatory failures have now been identified to such an extent that a “judicial Inquiry or Royal Commission” has been recommended¹¹ ([The Senate: Economics References Committee, 2014](#)). Such an Inquiry into conduct would complement the ‘root and branches’ Inquiry into financial system structure initiated by the Treasurer ([Hockey, 2013](#)) which has produced an Interim Report ([Murray, 2014](#)).

2.6. Preferencing the lender

Borrower and lender are both exposed by a failed loan but losses and costs are preferentially allocated to the borrower in an explicit allocation of responsibility (and implicitly blame) with a tax incentive and available mechanism for the lender to inflate arrears.

The convention of preferencing lenders survives from earlier times when banks carried loans for their life and incentives to bankers were much different. It persists despite increasing evidence of improper behaviours by lenders ([The Senate: Economics References Committee, 2012](#)), inadequate regulatory supervision ([The Senate: Economics References Committee, 2014](#)) and counter-productive government policies.

As seen above, a borrower is very unlikely to be the only ‘imprudent party’ in recent years. A sizeable number of failing bank loans were initially issued by one or other of the now-failed banks, and such loans are often regionally concentrated reflecting the sales ‘successes’ of target—chasing loan marketers. Allegations of negligence, incompetence or fraud, innocent or otherwise ([Galbraith, 2004](#)), should be investigated and resolved in depth, as should the practice of simply transferring an intact loan book, or part thereof, from a failed bank.

Such privileging of the lender rests on an assumption that a society needs to preserve financial capitals ahead of economic capitals. The privileging of lenders needs explicit justification. Societies historically vary privileging as [Galbraith \(1975\)](#) lucidly described. Central banks, however, have increasingly supported the primacy of finance, loans and the banking system. National governments from Austria through Ireland to the USA have also supported this. Yet varying oversight of the practices and prudence of financial parties is also evident. When such conventions become seen as entitlements, moral hazards become pervasive. If effective oversight is absent major failures can be expected.

[Mian and Sufi \(2014\)](#) highlight how the financial system received virtually all public funds made available to deal with the crisis in the USA since 2007, and how ineffective this has been.¹² Debts are concentrated in low net wealth entities that have a high propensity to consume. They note that with principal forgiveness, “debtors and creditors would have more evenly absorbed the shock to wealth... and boosted aggregate demand”. However, even then refinancing remains a problem as there is understandable reluctance to engage and restructure farm assets (with or without the current farmer) until the market appears to be bottoming. Effective circuit breakers are needed to stop the spiral down.

Whatever the trigger of a particular ‘farm business stress’ incident, a collapse in farm revenues, profitability and incomes is fatal when compounded by serious falls in farm values. Debts are then both unserviceable and inadequately secured. As spending tightens, rural aggregate demand is depressed. The flow through to the business community can be severe, especially when bankers direct farmers not to pay suppliers.

Today, subprime loans to Agriculture stalk ever more businesses in the bush. For the indebted, farmer equity levels have plummeted to below 50% nation wide. Stunningly, when revealing this appalling figure in mid 2013, then National Farmers President, Duncan Fraser, and CEO, Matt Linnegar, pushed “more research” when prompt, skillful actions could make a world of difference.

Stabilisation is needed. Untenable financial arrangements need restructuring. The sector needs recapitalisation, new institutional arrangements and, for a time, a hands-on approach from government. Insightful actions are needed to stabilise the sector and provide liquidity if the debt-deflation crisis underway is not to worsen.

¹¹ Recommendation 7 has received most press with its call for investigations, into amongst other things, “the misconduct of advisers and planners within the CBA’s financial planning businesses and the allegations of a cover up; ... any conduct that may amount to a breach of any law or professional standard”. There are potentially even more significant recommendations including 61 “a review of Australia’s corporate insolvency laws to consider amendments intended to encourage and facilitate corporate turnarounds”. This is an urgent need of farm businesses of all forms, especially with the current Commonwealth and State refusals to broker reconstruction.

¹² Essentially, the result has been to shuffle debt papers to new holders with no working through of problems, especially if securitisation or needlessly inflexible parties are involved.

3. Beyond subprime AG

3.1. “What does the fox say?”

Pop channels were abuzz with the clever song of this name during 2013. The song itself is catchy but ultimately empty. Great harmony and rhymes entertain us. Repetition of catchy but nonsensical phrases brings happiness, for a time. Now, after years of ignoring the warnings of Dunkley (1997), Stiglitz (2002), Saul (2005) and all the GFC’s sad experiences and needless destruction of wealth, it seems “Pop Internationalism” (Krugman, 1996) and the “Delusions of Global Capitalism” (Gray, 1998) still prevail in our confused GFC Act 2 haze.

Consider the specific Business Council of Australia (2014) recommendations for Agriculture:

1. *explore ways to aggregate farms to achieve greater economies of scale and to lift productivity, and attract investment. As part of this effort the government should review barriers to farm consolidation that exist due to state government planning and zoning laws*
2. *examine the introduction of economic and market incentives to better manage environmental values on agricultural land in order to allow more efficient and expansive use of landholdings*
3. *review ownership (nationality, corporate structure) and primary use of rural land with a view to determining the policy options available to government to incentivise aggregation.*

Aggregation and open access to farmlands for foreign investors are clear goals. “Environmental values” are to be managed with no mention of sustainability, or land condition. Governments are to relax laws and incentivise an “unlock the gate” process. Of course, we cannot blame the BCA and others for advancing their sponsors’ interests.

Now from Western Australia we hear reports of former Parliamentarians complaining on behalf of foreign buyers unable to obtain ‘large enough holdings’ and apparently blaming ‘disorganised’ WA farmers! When such statements are questioned the “they can’t take the land home with them” mantra is chanted, without the proper “but they *can* take the earnings” ending. Even senior Ministers and supposed industry leaders chant half-baked mantra without apparently appreciating the consequences of ‘soft dough’ policy thinking.

3.2. Market interference

‘Unusual incidents’ pervade not just the land market. Food trade has become increasingly impacted by political preferences. Without prior industry consultation or offers of compensation, the Australian government has not only established all manner of trade imbalances through unbalanced trade agreements but also actually stopped shipments: grain exports to Iraq, sheep to the Middle East, cattle to Indonesia and now anything to Russia.

Comments in response to the last are revealing. Despite Foreign Minister Julie Bishop stating “the Australian government will do everything in its power to minimise the impact on Australian farmers” of the \$400 million disruption from Russia, Agriculture Minister Barnaby Joyce “would hope that we’re able to manage it without direct assistance”. Such ongoing “do nothing (but hope)” emptiness is destructive.

Why is abject market appeasement still the first preference in Canberra? Perhaps stranger is the stated greater support from a Liberal Minister than the National. Have “the Country” and “the National” both left “the Party”, and who now speaks adequately for farmers? Time will tell.

3.3. Food bowl dreaming

Of course there is also the “Foodbowl to Asia” fantasy. Nirvana overload is evident in many discussions. However, if every picture tells a story, what is left out may reveal even more. Scan “Australia in the Asian Century” (Australia in the Asian Century Implementation Task Force, 2012) for key ideas with Leximancer and the Dream bubbles, shown in Fig. 2, appear. Simply assemble chosen ‘in’ words and you have a document that can be comfortably discussed in ‘policy circles’ around the nation. Words like market (350 instances), trade (336), food (191) and productivity (158) matter to the authors and the Canberra Consensus.

Is this really the way to prosperity? Among the missing ideas are profit (11 minor instances), debt (eight) and farmer (eight)—including from a case study of “Australia’s agriculture and food sector”. Income receives 140 mentions, but nearly all are Asian instances. Australian income (three) and Australia’s income (two) are insignificant—and only considered linked to productivity.

Recall that this ungrounded ‘century without profit, income or farmers’ report was emitted from the Australian Department of Prime Minister and Cabinet as a White Paper. What do Australians think of this biased preoccupation with the incomes of others? How could such fanciful emptiness masquerade as serious Australian national thinking, and what must other nations think? Although government has since changed, there has been no clear refutation or new thinking evident.

More fundamentally, and unfortunately for dreamers, productivity does not equal profitability. With a potential \$16b pa return on a posited \$1000 billion “food” investment (Port Jackson Partners, 2012), there appears absurdly little profit to be had. Impecunious industries and ever more debt from paddock to plate are more likely. Tragically, like shallow documents

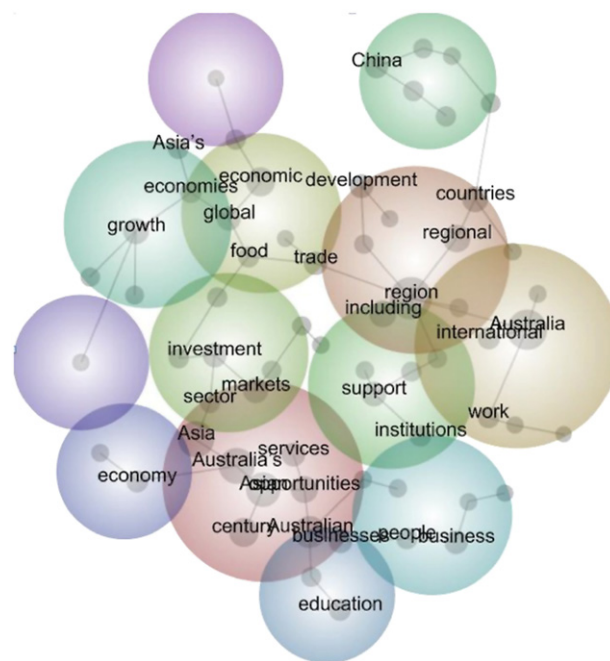


Fig. 2. Asian century: Pushing Australia down the Path to Penury?
Source: [Leximancer \(2013\)](#).

flow from many Departments. However, in recently shrinking the “Food bowl” fantasy, Minister Joyce took one useful step but even the “Deli” pretensions do not survive adequate analysis.

Still, in the Canberra Consensus industries that will support prosperity are simply dreamt up—with real contributors let slip away. Productivity is assumed adequate despite its documentable failure to deliver for decades now, as discussed in the next main Section. First, we will see how the disconnects become ever starker with analysis of Australian Agriculture's debt situation.

3.4. Rural debt realities

Today, the numbers of bank foreclosures and bankruptcy proceedings across agricultural and related industries challenge us all. While there are successes, they are too few. Factor returns are well below what is needed to maintain the sector-wide resource base, let alone develop it.

Industry-level financial numbers that do not add up, and often never did, trash empty pseudo-economic rhetoric. Incomes going nowhere will not service the recent debt run up, as is evident in [Fig. 3](#). Systemic failures allowed this development. How, for example, could anyone justify the run up in debt between 2003 and 2009 on other than speculative grounds? The failure was comprehensive, and on all sides.

There is much more documented ([Garnett, 2014](#); [McGovern, 2013b,c](#); [Rees, 2012a,b, 2013c](#)) but the broad institutional response has been to pretend that the *status quo* is delivering well.

3.5. Building more effective responses

In October 2012 Federal Treasurer Wayne Swan convened a “Rural Finance Roundtable” in Brisbane. Present from across the nation were over twenty ‘top-level’ representatives of Agriculture, Banking and Bureaucracy, Federal Agriculture Minister Joe Ludwig, North Queensland MHR Bob Katter, a number of farmers from across the nation and a couple of academics. Each was asked to express an opinion. It was an illuminating but frustrating experience. The Rural Finance Roundtable Working Group (RFRWG) was established at an open-invitation meeting held the next day at the Queensland University of Technology.

RFRWG members, including your author, have comprehensively researched many issues and situations. Discussions have been held with all manner of parties who individually showed considerable interest, insights and concern. Many seemingly skilled, insightful and decent people recognise the seriousness of the situation. Collectively, however, progress has been minimal. While we may speculate about such individual and collective failures to act ([McGovern, 2010](#)) current problems now need urgent direct actions.

From many examples, three comments contribute potential explanations for current collective failures to address mounting problems. Quotes are not exact.

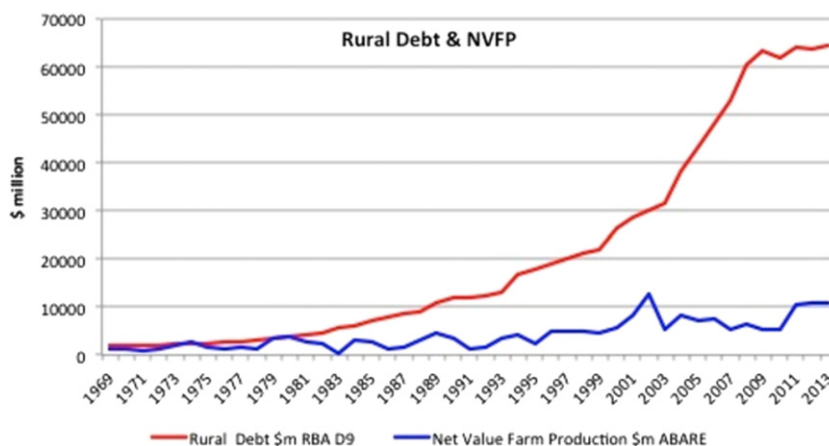


Fig. 3. Debt has outpaced the ability to service it.
Source: Rees (2013c).

- “With my union background, you can’t appreciate how great a journey it was... (to fight for farmers)” from a reflective former Agriculture Minister, Senator Joe Ludwig, who ‘against the odds’ worked up and initiated “Farm Finance” in the 2013 Budget.
- “I am tired of coming to meetings where we go around the room and each of us bankers says ‘we have no problems’. I do, and we all know we do”, a banker at a meeting with farming representatives in Queensland.
- “It seems to be so obvious and to make sense”, another Senator (now Minister), echoing an oft repeated thought from the Liberal National side, after being briefed on the 2013 Reserve Bank Amendment Bill discussed below.

Lessons that can be drawn are many.

Past positions need to be refashioned as the world changes, and this takes courage and energy. New realities need to be accepted, and denial only deepens problems. Approaches with potential need to be critically, sensibly and energetically pursued. This is the challenge for the current government.

Australians have always prided themselves on an ability to effectively surmount adversities by working together. Indeed this is a hallmark of the national narrative, one memorably captured in statistics revealing markedly greater survival rates for Australians held in Second World War and forced labour camps. Lest we forget.

3.6. An Australian Reconstruction and Development Board within the Reserve Bank of Australia

This proposal arose out of RFRWG discussions and research that revealed the:

- sheer desperation of farmers and great uncertainties for their businesses and families,
- clear inadequacies in the design and implementation of financial products,
- rising stresses and risks faced by nearly all enterprises, and their communities,
- failure by the Commonwealth and States to implement any reconstruction activities,
- clear impediments to new entrants into Agriculture,
- ongoing poor profitability of agriculture and related industries, and
- ongoing decline of factor incomes and capitals.

The comprehensive nature of failures meant that major reforms to financial arrangements are necessary.

This was given increased urgency when the Commonwealth and States withdrew Exceptional Circumstances Support in mid 2013 with no transition plan in place. The interest rate subsidy (EC IRS) had allowed banks in poor years to carry loans they otherwise would have had to call in. EC IRS was effectively a guarantee of some sectoral interest servicing. Explicit warnings of the risks of EC IRS removal from the Australian Bankers Association (ABA) and meetings at Merrinden and Colac were ignored.

With EC IRS pre-emptively gone, farmers stand immediately financially exposed by adverse circumstances. Interestingly, the [Australian Bankers Association \(2014\)](#) submission to the “Competitiveness” White Paper includes five suggestions of how to tailor better farm finance. Sadly, each involves risk transfer, via an explicit or implicit government guarantee and all but one rely on subsidisation through the taxation system. Individual bankers who understood the needs and talked insightfully about new possibilities must be frustrated.

An Australian Reconstruction and Development Board (ARDB) could move us past such impasses. Facilitating improved financial arrangements and ‘fit for purpose’ financial products will be an important task for the ARDB. Reconstruction is another. Development bank activities are the third specified task. The Board enables the RBA to be more active and effective

in dealing with emerging and existing financial problems that present undue sectoral or systemic risk. Too often in the past, well-based warnings given by the RBA have been ignored.

“the household sector is running a highly mismatched balance sheet, with assets consisting mainly of property and equities, and liabilities comprised by debt. This balance sheet structure is very effective in generating wealth during good economic times, but households need to recognise that it leaves them exposed to economic or financial shocks that cause asset values to fall and/or interest rates to rise” (Battellino, 2007).

When the Deputy Governor of the Reserve Bank of Australia made such a clear statement we could reasonably have expected responses. There were none. Seven years later we live with the legacy of this foolish inaction.

Capacities developed under its third Board will help the RBA rectify such problems. Micro-prudential responses can be instituted when problems are first evident. The initial ARDB focus is “Agriculture, associated industries and infrastructures” but provisions exist to enable it to focus on other sectors where adverse developments appear.

Essentially the ARDB is to help rectify systems failures that distort and corrupt financial markets. Sectoral financial sustainability is to be improved directly for Agriculture, associated industries and infrastructures. Rural finance will be de-risked with capital efficiency and efficacy increased.

The ARDB, like other RBA Boards, would work within the financial system. It is not a government Department and would not be funded by the Commonwealth Budget. The RBA exists as a bank chartered to act in the national interest, unlike the commercial operators currently in play and many overseas central banks. Profitable and productive industries are in the national interest, as history and research demonstrate. Obviously the RBA should also seek to trade profitably over time, and a well-conducted ARDB would assist the RBA to meet this goal and to provide enhanced dividends to the Australian government.

3.7. A multi-faceted challenge

The challenge is multifaceted. Financial products currently available to farm and related businesses are (1) inferior in design and (2) risk raising. The (3) unwinding of (4) prior poor lending practices presents (5) immediate systemic risks, (6) serious illiquidity and (7) untoward wealth destruction. Further, no basis for (8) sensible industry recapitalisation exists and there are (9) effective barriers to entry, especially for (10) young Australians wishing to farm. Any one of these facets is itself a major problem. *Together they imperil even the best enterprise and will extinguish sectoral capacities.*

On the ARDB, enabling legislation is under review by [The Senate: Economics Legislation Committee](#) (current, with completion December 2014). A wealth of information is at hand with 145 written submissions and a range of witnesses to call as well as a depth of understanding developed in several relevant previous Senate Committee Inquiries ([Senate Rural and Regional Affairs and Transport References Committee, 1994](#); [The Senate: Economics Reference Committee, 2011](#)). Additional information has been posted by [McGovern \(2013a,d\)](#) and [Rees \(2012a,b, 2013a,b\)](#).

Still, [Australian Treasury \(2014\)](#) blandly submits that “in a well-functioning financial system, capital is allocated to more productive sectors in the economy”. This assertion presents a real conundrum as outstandingly productive Agriculture, our only “strongly competitive” sector, is having trouble attracting capital. In passing Treasury confirms the trebling of farm debt in fifteen years as well as the farm cost-price squeeze but provides no detailed analysis to support its many general assertions. No suggestions are made as to how to solve evident problems. Instead, mantras are evident with “productivity” mentioned seven times, “profit” twice.¹³

It is time for true engagement on these issues, not parallel playing with disconnected submissions while problems deepen and spread more widely. Clearly, the time for irresponsible national pretence and inaction is now over.

“We’ll leave behind our fallacies and make a new beginning.

We have to choose to win or loose and it’s time we started winning.” Coulter (2005, with one edit).

4. The wider Australian situation

It is tempting to think that such things could only occur far from our sophisticated cities. “Australia, after all, is doing well” is the thought comforting many. Twenty plus years of uninterrupted growth is not to be dismissed lightly.

4.1. Mounting external imbalances

Unfortunately, much Australian growth has been externally debt funded with inadequate income generation. The sorry net result for Australia’s nationals is seen in [Fig. 4](#).¹⁴ Fortunately and as previously discussed ([McGovern, 2011](#)), much of the

¹³ The profit of the RBA and profit as a consequence of productivity are the two instances.

¹⁴ Note that this is not government debt. It is the net position of all “Australian entities” transacting financially with the rest of the world. Australian banks, governments, corporations, citizens and others active off shore net to the annual balance (blue line) and cumulatively have built increasing offshore obligations. These comprise the net external wealth of a nation, which is negative for Australia but positive for those nations that run persistent surplus balances on the full current account.

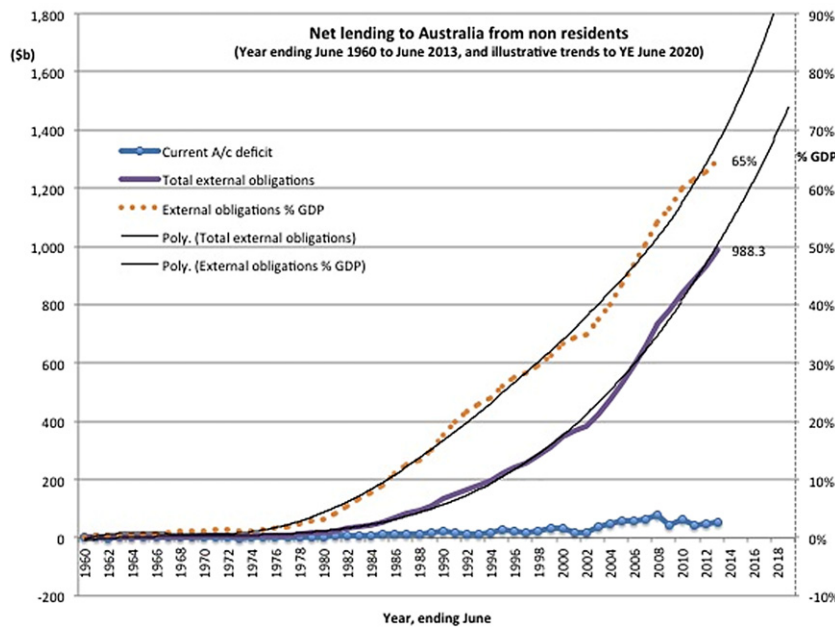


Fig. 4. Australia, now toying with a balance of payments crisis?
Source: Australian Bureau of Statistics (2013a).

obligation is held privately and in Australian dollars. Still, the trend is unsustainable and the costs of servicing are depressive. A net surplus on merchandise trade of around \$A 40b annually is needed for Australia to just tread water in its deep pool of debt. We are currently nowhere near that.

The lack of any response to these issues, also raised by Schwab (2009) and Gittins (2010),¹⁵ and extensively on Barnaby is right (2012, 2013, for example), sees us markedly more pessimistic about Australia's prospects. With nothing done, external obligations rose by \$A104b over the last two years. Underlying concerns are unappreciated *de facto* guarantees and pressures building for foreign currency denomination. These, the deterioration in public finances and falling incomes set Australia as "crisis prone". The Long Run Borrowing Constraint can be expected to become operational with associated major liquidity problems when any sharp revision in external expectations occurs.

Things are now getting tight with external obligations now over \$1000b. As with Agriculture, there has been zero effective recognition of exposure, let alone apt responses. The persistently and uncomfortably high Australian dollar has not only depressed the incomes of farms and other exporting businesses while advantaging imports against domestic products. It has also kept Australian interest rates and the cost of offshore borrowing high. One maintains the other tightening the trap. Today, balance of payments disequilibria do not self correct as they once did under Bretton Woods. Instead they continue to build until crisis onset forces major wealth- and capacity-destroying adjustments.

4.2. Domestic tightening

Recent indications are that the real economy can no longer support the imposts. Price changes measured via the CPI or the GDP Deflator can be used to adjust nominal housing interest rates to indicate real interest rates. The two price series (shown at the top of Fig. 5) have generally moved reasonably together since the 1960s. However, they appear to have diverged since 2002 with opposite trends in the most recent years. The CPI trend is reasonably steady with a slight downward trend. However, the GDP deflator rose to a 2008 peak and is now trending strongly downwards with deflation in the years ending June 2013 (−0.3%) and 2014 (−1%), something probably not seen since the 1930s.

The estimation of real interest rates is thus markedly different for years since 2002, as shown in the lower part of Fig. 5. The CPI adjustment produced higher real rates than the GDP deflator which indicates easier monetary conditions prior to 2012. Now things are reversed. The CPI based real interest rate of 2.9% per annum contrasts with a millennial real high of 6.9% per annum as the negative GDP deflator raises real above nominal rates for a second year running.

The inconsistencies between the two series are stark. Adjustment using a CPI basis points to moderate inflation and interest rates while using the GDP deflator indicates deflation and very high real housing interest rates. Notionally, the GDP deflator should provide a more comprehensive measure, indicating a need for much lower nominal interest rates. Of

¹⁵ Gittins provides a good account. The key question is whether the external debt has funded asset developments that produce sufficient servicing incomes. With the continuing rise in obligations and high dollar we have become much less sanguine about prospects.

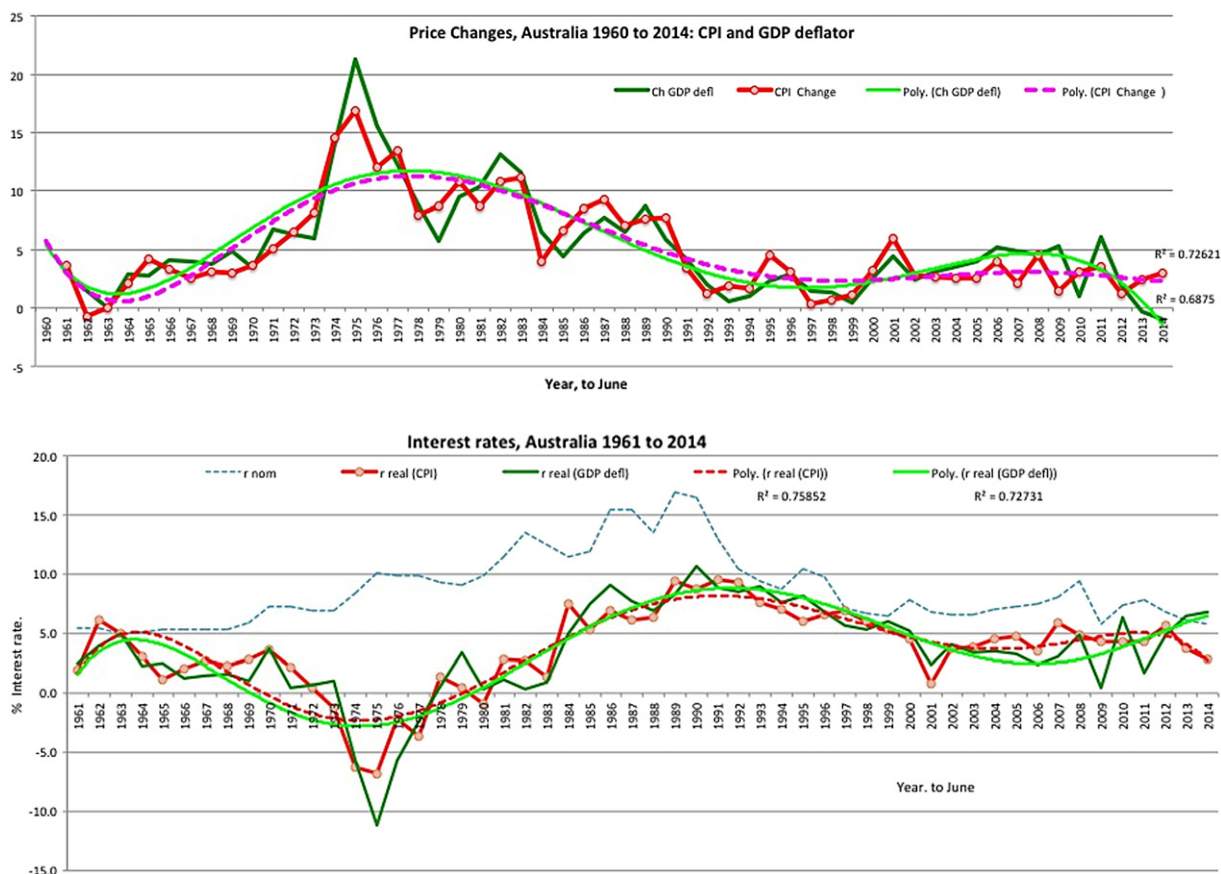


Fig. 5. Australian inflation and interest rates: the tails of two series.

Source: Australian Bureau of Statistics (2013b, 2014a); Reserve Bank of Australia (2012).

concern, is that the GDP deflator has dropped 20% over several years in some stressed nations during the early GFC while their CPI varied little. So the critical question is not just “*are we measuring the right things?*” but also “*are we using (price) measures appropriate to (economic or financial) situations?*”

4.3. Uncertain incomes

Turning to national income reveals another interesting indicator of an economy under stress. While it is often proclaimed that Australia has experienced positive economic growth for over twenty years the two *per-capita* series¹⁶ in Fig. 6 indicate periodic declines in domestic product and national income.¹⁷ For example, GDP per capita peaked in the June 2008 quarter, fell for three periods then took six further quarters to revisit the 2008 high in the September 2010 quarter.

The dips in *per capita* incomes¹⁸ in 2010 and 2013 contrast with the very slight GDP per capita dip in 2009 and 2010. Also the income measure reinforces that Australian GDP does not fully accrue to Australians due to a net outflow of investment earnings to overseas investors (as shown earlier). Such imbalances account for the key part of the difference each year between the values of ‘what is produced in the territories of Australia’ and ‘what is earned by Australians, at home and as net repatriated from offshore’.

¹⁶ *per capita* estimates remove the effects of population growth.

¹⁷ Recall that ‘domestic’ refers to values of activities occurring in the territories of Australia while ‘national’ is that associated with the entities defined as Australian. Foreign investments add value domestically but returns on investments accrue off-shore, setting incomes below value added. It is incomes that service debts and like obligations.

¹⁸ “Real net national disposable income is calculated by: taking real gross domestic income; deducting real incomes payable to the rest of the world; adding real incomes receivable from the rest of the world; and deducting the volume measure of consumption of fixed capital. Real incomes payable and receivable are calculated by dividing the nominal income flows by the implicit price deflator for gross national expenditure. In the derivation of the aggregate all of the adjustments are made using the chain volume aggregation method used to derive all of the ABS chain volume estimates”. Australian Bureau of Statistics (2013b) RnNDI *per capita* is estimated by ABS.

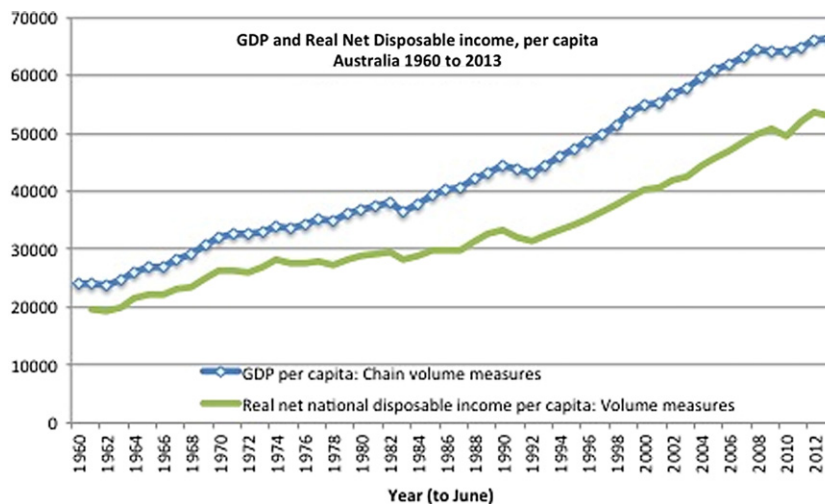


Fig. 6. Economic performance, per capita.
Source: Australian Bureau of Statistics (2013a).

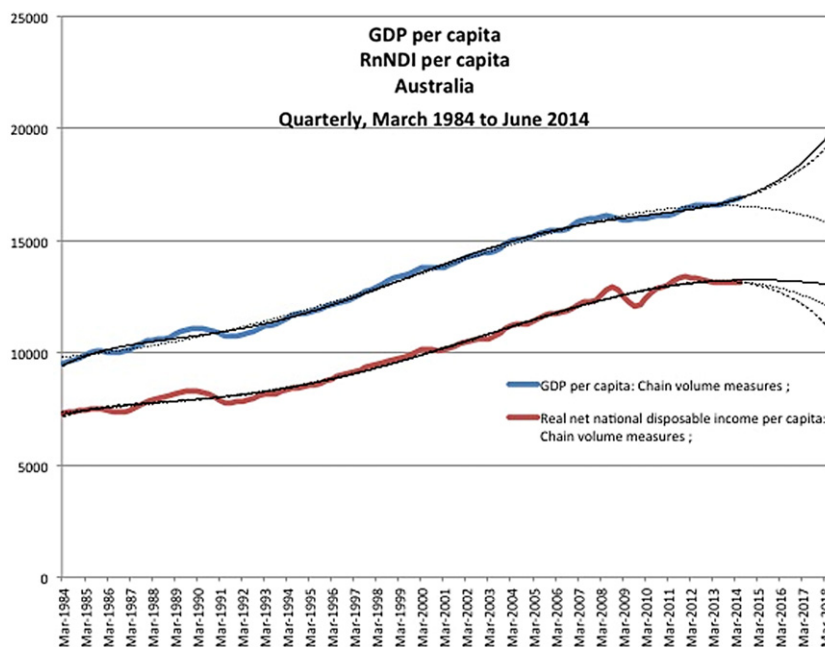


Fig. 7. Observed and prospective quarterly economic performance, per capita.
Source: Australian Bureau of Statistics (2014b).

Quarterly figures to June 2014 provide a closer look, as shown in Fig. 7. The 2011 December quarter peak was at \$13 406 with \$13 156 estimated for June 2014. This is an income drop of \$250 or two percent over ten quarters.¹⁹ Meanwhile, GDP grew quietly. Currently the two series seem to be diverging, something reinforced by the three four-year projections for each series. All income projections are down, slightly to markedly. Meanwhile, GDP rises for two of the three extrapolated trends. Matched order polynomial pairs are used. All show similarly high correlations.

A disaggregated analysis is needed to discern the status of the economy more fully. However, there seem to be more than enough grounds here for new policy initiatives and serious contingency planning. Falling incomes and economy-wide deflation while consumer prices rise and real interest rates remain very high in a heavily-indebted nation is evidence of a debt-deflation downturn in its early stages.

¹⁹ Clearly some care needs to be taken in interpreting these quarterly figures. The previous series publication to March 2014 showed a \$217 drop with a slightly different pattern of change. The November release of the Annual series may provide both some clarification and further revisions.

The drop in disposable income per capita can help explain not only the rejection of the Commonwealth Budget but also a financial ill-ease evident within the population. Currently, the Commonwealth through the Treasurer is seeking to strongly preference its debt servicing obligations just when households and firms are receiving falling incomes and already struggling to hold their balance sheets together. Discussions with financiers confirmed the presence rising household financial stresses *before* the recent rise in unemployment. Problems are exacerbated in those states where utilities have raised prices to help State debt servicing. All will be much worse off if this depressive synchronisation is allowed to continue. Even though Senate actions have delayed some imposts on the population for three years, it seems that other imposts must also be delayed.

4.4. *Net worth and balance sheets*

Financial crises initially centre on low net-worth entities, be these farms, households, banks, governments or other financial entities. Problems are likely to be spatially concentrated and triggered by servicing or security concerns. Inadequate or uncertain incomes underwrite the first. Falling values of collateral offered as security²⁰ signal the second. In 'normal times' rectification is sought by selling the collateral to raise funds that are then applied preferentially to the debt and costs of loan finalisation. Any residual is then returned to the borrower.

These are not normal times. Problems compound as the value of collateral falls or when the collateral is not tradeable or saleable. Such things have already occurred with Australian farm loans, and they appear to be worsening. Circuit breakers are needed to arrest financial implosions and allow time to address "*highly mismatched balance sheets*" wherever they occur.

Productive capacities need to be maintained as best we can while financial stabilisation is allowing prudent rectifications to occur expeditiously. Economic capacities once lost or allowed to run down are expensive to replace or renew, and significant incomes are lost in the process.

A signature trait of financial crises is that interest rates fall heavily. Yet this is insufficient as the malaise affecting nations with near zero nominal interest rates demonstrates. A trap builds when crises reduce capital returns to such an extent that (relative or absolute) capital scarcity arises, raising the costs of capital further above returns. The question of "why borrow at 7% real when (risky) returns are (probably at best) 3%, and asset values might fall (further) too?" demonstrates such a trap in action in many people's minds today.

5. Conclusion

So what does the future offer? While none of us know we should all be actively making it better, individually and collectively. That is the hallmark of an inclusive enterprising society. Final comments are offered under four headings. Each presents specific challenges.

5.1. *Time warp*

Advocates of naïve competitiveness and productivity have for years effectively supported a pervasive hollowing out of the Australian economy with increasing external dependence on corrupted supply chains. Now in Agriculture and elsewhere BCA et al. would consolidate external supply chain dominance. How then might Australia pay its way in the world?

The Canberra Consensus, and its global cousin, are under attack from many directions. The pressures variously building from imbalances across the nation(s) are many, serious and too often denied. Prioritising austerity is just the wrong policy choice under current and emerging conditions (as many European governments are belatedly recognising).

Sometimes it takes a new perspective or party to sort things out. The Australian government elected in 2013 initially spoke of Agriculture in terms of profitability and the like. This showed real promise. However, the current White Paper title and briefing materials prioritise competitiveness. It seems some wish to stay in a mind set from a world now past.

5.2. *Situation*

Clearly there are major problems confronting Australian Agriculture and associated industries. Incomes are irregular and too often insufficient to maintain the factors that feed us. Finances have deteriorated and mortgages have become evidently subprime. For many, falling incomes and asset values confront high debt levels. Liquidity is an issue.

For the nation as a whole:

- real net national disposable income per capita peaked in the September 2011 quarter and has since fallen by \$250 or 2%;
- GDP per capita rose \$575 or 3.5% over the same ten quarters;
- the GDP deflator indicates that deflation economy wide which began in 2012–13 has continued with a 1% fall in the year to June 2014; and
- the CPI indicates still modest rising inflation in consumer products, with a value of 3% in the year to June 2014.

Choice of measures makes a major difference. Real housing interest rates are either very high at 6.9% (using the GDP deflator) or modest at 2.9%. Unfortunately, the estimates that are conceptually most reliable are both telling the same tale of

²⁰ Examples include: real properties such as farms; shares; bonds; bank-issued 'notes' and other commercial papers. Falling values of such collateral sees deterioration in LVRs that signal lender exposures and potential need for rectification.

decline. Further, Australia's entities continued as net external borrowers adding \$104b to external obligations in two years. Yet nothing was said. No action was seen. No one who knew then cared or felt able to act, it seems. And if no one knew, that is an even more damning indictment.

Most have yet to recognise let alone think about current challenges. A major downturn appears most advanced in rural Australia where industries are highly exposed to not just market uncertainties but also the strategic meddling of private and public interests, onshore and off. Provided estimates indicate that the downturn has spread unnoticed to the whole economy. Again situations will differ by region and industry. There remains but a little time for effective pre-emptive actions, but Christmas may tell. After that, in the words of one experienced rural accountant, "there will be blood everywhere."

5.3. Reform

Real solutions require substantial possibilities for income, investment and profitability under uncertainty. Finance matters as do market and supply chain realities. Policy has avoided these things for too long, to the great cost for Agriculture, other infected industries and Australia. The resilience of rural areas is greatly depleted as a result, with urban areas now following.

The foundational structural reform needed is in industry, governmental and organisational thinking. The old tired agenda ([Business Council of Australia](#), [Access Economics](#), & [Allen Consulting Group](#), 1991, for example) has manifestly failed Australia. Scale and competitiveness policies that have delivered for a few at the expense of the nation need to be discarded, not re-venered.

Still high real interest rates, stressed balance sheets and deteriorating factor returns are immediate concerns. Restoration requires serious attention to underlying dynamics and imbalances that, if left uncorrected, would deliver our own version of the needlessly destructive events that have plagued and impoverished others. Mutual accommodations need to replace unilateral entitlements.

Australians need to actively build solutions that can move us past these subprime times with minimal needless losses. Effective strategy includes being able to deal with 'low probability–high impact' events as well as the routine. Australia has weathered the first phase of the Global Financial Crisis well but we now need to adeptly reposition ourselves as the second phase unfolds. Strategies used with limited success elsewhere need to be critiqued, not uncritically adopted. Disconnects need to be rectified if we are to stabilise national capacities, manage wealth and inclusively renew the foundations of our economics successes.

5.4. Paradise lost, or regained?

Australia is seen as a paradise by many. However, it is instructive to recall that Argentina and Australia shared many similar economic characteristics more than a century ago but sadly Argentina became lost on the way. Now its fourth 'triple financial crisis'²¹ variant of recent times (1980, 1995, 2002, 2014) is underway. The estimated cost of the 1980–82 banking crisis alone was 55% of GDP²² ([Feenstra and Taylor](#), 2011).

It is hard to imagine the degeneration that accompanies serious financial crises, but this example which followed Argentina's 2002 world record default and seventy percent peso exchange rate collapse (*op cit* p. 403) gives some insights:

"Word spread fast through the vast urban slums ringing Rosario. There was food on the freeway – and it was still alive. ... A mob moved out from Las Palmas, a shanty town of trash heaps and metal shacks boiling over with refugees from the financial collapse of what was once Latin America's wealthiest nation. ... 'Kill the cows' someone yelled. 'Take what you can.' ... And the slaughter began... fights broke out for pieces of flesh in bloody tugs of war..."

"Until last year, Argentines were part of the richest, best-educated and most cultured nation in Latin America. The poor here lived with more dignity than their equals anywhere else in the region. ... Severe hunger and malnutrition have emerged in the rural interior—something almost never seen in a country famous for great slabs of beef and undulating fields of wheat..."

Australia is *not* Argentina, but if inaction continues events there *could be* tragically mirrored here over the decades to come. There are insights to be gained, and we would be foolish not to seek them. There also remain very good opportunities for Australia to rectify situations and break the destructive trends to nowhere good. Real remedies are needed, however, not a papering over of problems.

Since the shock of 2008 there has been a rising tide of high quality academic works that provide insights into our current dilemma. Such insights need to be connected and built further. We will not move past current problems and the prospects of more crises until we discard the thinking that blinded us to them in the first place.

A new, effective agenda needs to be set with shared responsibilities taken for rectification. 'Beggars' policies *between* nations are often blamed for earlier Depression-era miseries. This time it seems that 'beggars' policies *within* nations are prolonging the GFC and markedly raising risks, both within nations and within global systems.

²¹ The focal types of financial crisis typically involve banking system insolvency, default by government or currency collapse. Each reflects specific imbalances in payments expected and realisable. Links to the real economy are typically direct, quick and severe.

²² This is the same level of loss as experienced by Indonesia in the 1997–98 Asian crisis and ahead of the 47% loss estimated for China during the 1990s.

Australia as G20 host could make a great contribution to humanity by initiating and hosting constructive dialogues that focus on inclusionary solutions and mutually-beneficial rebalancing. Current exclusionary stances are simply perpetuating problems and ignoring foundational flaws. Unfortunately, many promising past G20 discussions have faltered, as seen with currencies. The needed conceptual and practical bridges were missing. Without bridges, isolation builds. With isolation, hostility arises too easily. The Australian government is well placed to be a great bridge builder, off shore and at home. First, though, it needs the will to make a real difference.

Real gains could be quickly achieved in rural and urban areas if actions discussed were critically reviewed and appropriately enacted before Christmas, this year. The downward spiral could be arrested before it gathers more momentum and while remediation is tenable. We all have real work to do, and action is overdue.

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