

The Treasury's Submission to

**The Senate Economic Committee Inquiry into the
Reserve Bank Amendment (Australian Reconstruction
and Development Board) Bill 2013**

February 2014

Contents

Introduction	2
The Australian agriculture sector.....	2
PRODUCTION	2
EXPORTS.....	4
FARM STRUCTURE AND EMPLOYMENT	4
RURAL DEBT	5
Government programs.....	6
TRANSITIONAL FARM FAMILY PAYMENT.....	6
FARM FINANCE	6
RURAL FINANCIAL COUNSELLING SERVICE (RFCS).....	7
FARM MANAGEMENT DEPOSITS (FMD)	7
Rural reconstruction and development board	7
CONSIDERATIONS	8
STATE-OWNED BANKS	9

INTRODUCTION

1. The proposal to establish a Rural Reconstruction and Development Board under the Reserve Bank of Australia has been put forward to address financial difficulties that some Australian agricultural firms face.
2. The proposal raises substantial concerns for businesses, individuals and the Government. Direct lending via a government-owned Development Board is likely to reduce competition and innovation across the economy by crowding out private providers of credit. This view is supported by overseas experience, which finds that the presence of state-owned banks generally hampers economic growth and distorts the financial system.
3. The agriculture sector plays an important role in the Australian economy and is a major driver of economic activity in rural and regional Australia.
4. The sector faces many challenges, including rising cost pressures, high levels of debt and income variability due to unfavourable weather conditions.
5. The Government provides a range of assistance to address these challenges, including farm family payments, concessional loans and financial counselling services.

THE AUSTRALIAN AGRICULTURE SECTOR

6. The agriculture sector is important to the Australian economy and is a significant driver of economic activity, particularly for many parts of rural and regional Australia.
7. The economic contribution of the agriculture sector varies across the States and Territories—output, as a share of gross state product, is higher than the national average in South Australia and Tasmania and below the national average in Queensland, Western Australia, New South Wales and Victoria¹.

PRODUCTION

8. The agriculture sector's gross value of production was almost \$52 billion in 2012-13, and is forecast to grow to over \$55 billion in 2013-14². However, the sector's share of the economy has nearly halved, falling from 4.6 per cent in 1989-90 to 2.4 per cent in 2012-13³.

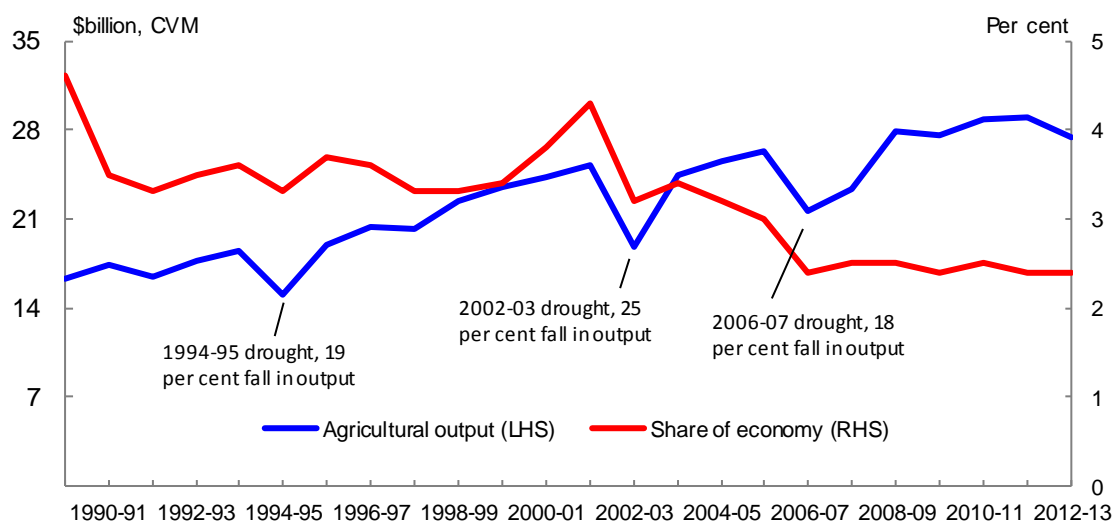
¹ ABS Cat 5220.0, *Australian National Accounts: State Accounts*, 2012-13.

² ABARES, *Agricultural Commodities: December Quarter 2013*.

³ ABS Cat 5204.0, *Australian System of National Accounts*, 2012-13, Table 5.

9. The sector's output has grown on average by 2.3 per cent per annum since 1989-90 with the sector being highly sensitive to external factors such as weather conditions (Chart 1).

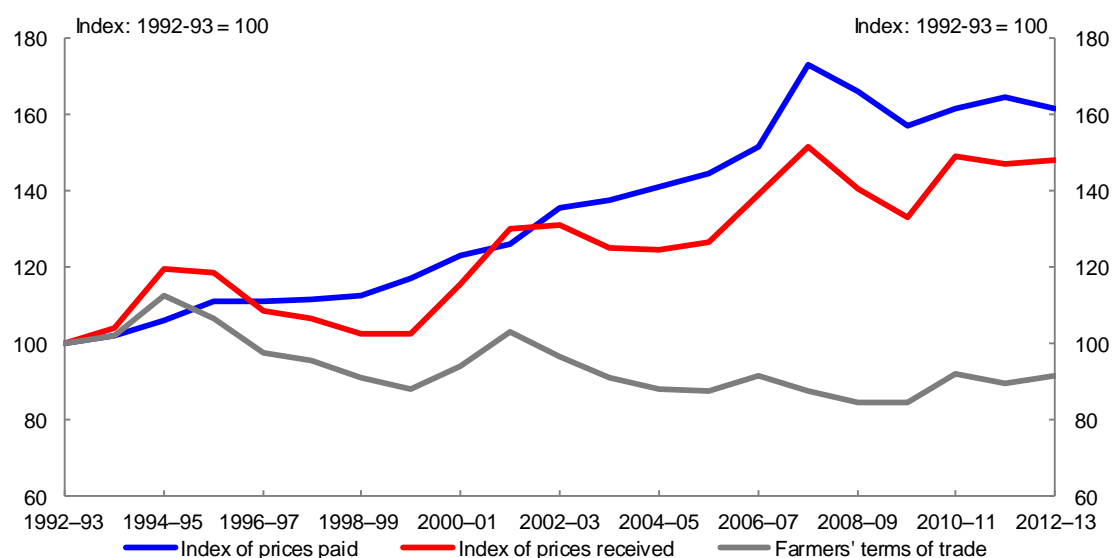
Chart 1: Australian agricultural output⁴



Source: ABS catalogue number 5204, Table 5.

10. Over the longer term, there have been rising cost pressures on Australian producers, although the farmers' terms of trade⁵ have remained steady in recent years. The rising cost has necessitated increases in productivity in order for farmers to remain profitable and keep operations viable (Chart 2).

Chart 2: Farm costs and prices received



Source: ABARES, *Agricultural Commodity Statistics 2013*, Table 13.

⁴ Treasury notes that the statistics presented reflect the agriculture sector as a whole, and the experiences of individual firms may differ.

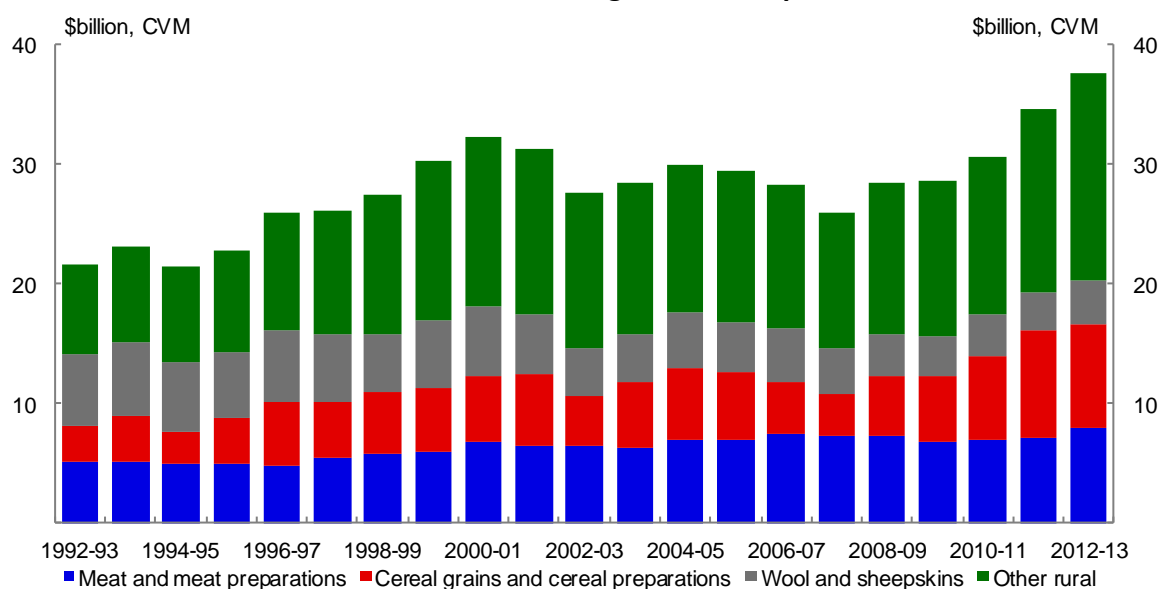
⁵ The farmers' terms of trade are the ratio of the prices farmers receive to the prices farmers pay.

11. Despite experiencing declining labour productivity in 2012-13, the agriculture industry over the past five years experienced high annual labour productivity growth (above its 15-year average).

EXPORTS

12. The agriculture sector has become increasingly export oriented in recent years. In 2012-13, export earnings for Australian farm commodities were \$38.0 billion, accounting for 14 per cent of Australia's total goods and services exports. In the year, Australia's main farm exports were wheat (18 per cent), beef and veal (13 per cent) and wool (8 per cent). Combined, these industries represent 38 per cent of total agricultural exports.

Chart 3: Australia's agricultural exports



Source: ABS catalogue number 5302.0

FARM STRUCTURE AND EMPLOYMENT

13. In 2012-13, the agriculture sector employed 278,000 people⁶, comprising approximately 2.4 per cent of Australia's total employment. The agricultural workforce has a number of distinctive features, including a high proportion of self-employed, family and casual workers, long job tenure and a relatively old workforce⁷.
14. The average size of Australian farms has risen by 10 per cent over the past 30 years. While there has been a 19 per cent reduction in the area of land in agricultural

⁶ ABARES, *Agricultural Commodity Statistics 2013*

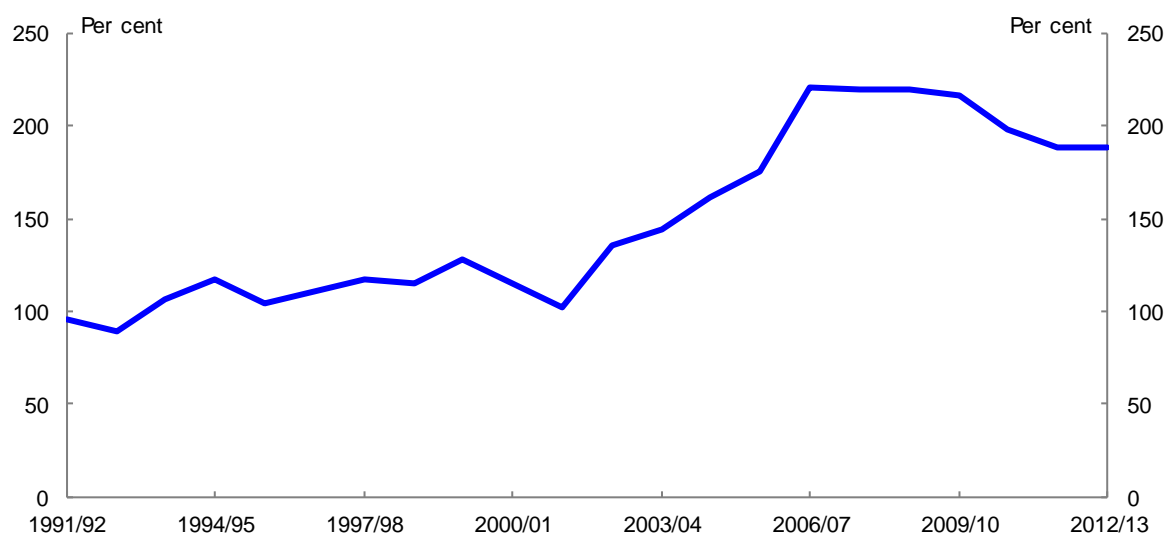
⁷ Productivity Commission (2005), *Trends in Australian Agriculture*.

production, the number of farms has fallen by less, with significant consolidation in the sector resulting in the number of farms falling by 28 per cent⁸.

RURAL DEBT

15. Rural debt has trebled over the past 15 years. The rise reflects increased availability of credit due to financial deregulation in the 1980s and introduction of inflation targeting in the 1990s, as well as consolidation of farms that are able to service larger debts.
16. The level of rural debt rose from around 100 per cent of rural output⁹ in the early 90s to almost 200 per cent in 2012-13 (Chart 4). This compares to increased indebtedness across other sectors in the economy. For instance, household debt-to-disposable income ratio¹⁰ rose by almost 100 percentage points to 146 per cent and the aggregate credit-to-GDP ratio grew from around 80 per cent to around 140 per cent over the period.

Chart 4: Rural debt as a share of rural output



Source: RBA and ABS catalogue number 5204.0

17. The increased indebtedness has been used for on-farm investment, particularly land purchase, and to finance ongoing working capital requirements¹¹.
18. Much of the debt is held by a relatively small proportion of mostly large farms, with farms in Western Australia, the Northern Territory, Tasmania and South Australia having the largest average debt (Table 1).

⁸ ABARES, *Agricultural Commodity Statistics 2013*

⁹ Gross value added by the agriculture, forestry and fishing industry

¹⁰ RBA, statistical table B21

¹¹ ABARES, *Agricultural Commodities: September Quarter 2013*

Table 1: Average farm debt at 30 June 2012 (\$'000)

Type of farm	NSW	VIC	QLD	WA	SA	TAS	NT	Aus
Broadacre	446	291	568	886	391	255	1,746	480
Dairy	647	633	273	994	1,066	1,744	NA	702

Source: ABARES, *Agricultural Commodities: September Quarter 2013*

GOVERNMENT PROGRAMS

19. There are a range of programs provided by the Australian Government to support farmers and farm businesses.

TRANSITIONAL FARM FAMILY PAYMENT

20. The Transitional Farm Family Payment assists farm families who are experiencing financial difficulty to manage the impacts of climate variability and market fluctuations. The program is available until 30 June 2014. The Transitional Farm Family Payment is paid at a fortnightly rate equivalent to Newstart Allowance.
21. As of 1 July 2014 a new Farm Household Allowance will be available. The new allowance will provide eligible farmers and their partners who are experiencing financial hardship with assistance and support to improve their long-term financial situation, regardless of the source of the hardship. Assistance will be available without the need for a drought or an Exceptional Circumstances declaration.

FARM FINANCE

22. The Australian Government's Farm Finance program has four measures which aim to build the ongoing financial resilience of farm businesses:
 - short-term assistance in the form of concessional loans for productivity enhancement projects and debt restructuring;
 - funding for around 17 additional fulltime counsellors with the Rural Financial Counselling Service;
 - increasing the non-primary production income threshold to make Farm Management Deposits (FMDs) from \$65,000 to \$100,000, and allowing consolidation of existing FMDs; and
 - establishing a nationally consistent approach to farm debt mediation.
23. Concessional loans will be available for productivity enhancement and debt restructuring. The types of loans offered vary between jurisdictions depending on what each state considers best meets the needs of its farming sector.

RURAL FINANCIAL COUNSELLING SERVICE (RFCS)

24. The RFCS Program provides grants to state and regional organisations to provide free rural financial counselling to primary producers, fishers and small rural businesses who are suffering financial hardship and who have no alternative sources of impartial support. There are currently 14 service providers employing more than 110 rural financial counsellors across the country. The RFCS Program is jointly funded by the Australian and state governments.

FARM MANAGEMENT DEPOSITS (FMD)

25. The FMD scheme is designed to assist farmers and primary producers become more self-reliant, deal more effectively with fluctuations in their cash flow and manage financial risk. The scheme allows eligible primary producers to set aside pre-tax income from primary production in years of high income, which they can draw on in years of low income.
26. Income deposited as an FMD is tax deductible in the year the deposit is made so long it is not withdrawn for 12 months. It becomes taxable income in the year in which it is withdrawn.
27. Overall this has this has the effect that the individual defers the tax that would otherwise be paid when the income was earned until the time they withdraw the amount from the FMD.

RURAL RECONSTRUCTION AND DEVELOPMENT BOARD

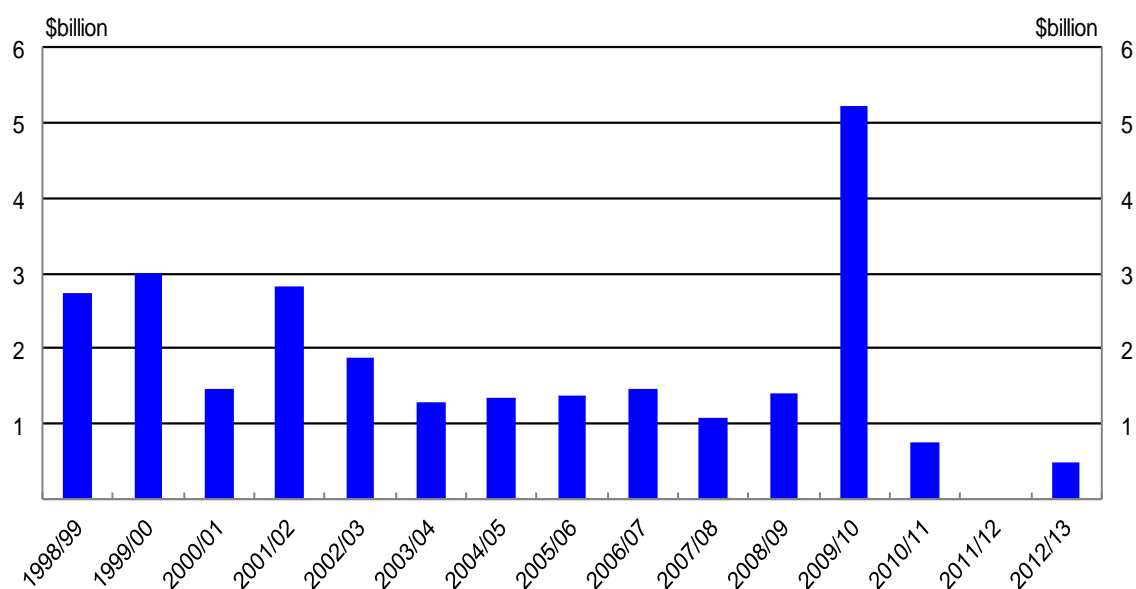
28. The proposal to establish a Rural Reconstruction and Development Board under the Reserve Bank of Australia has been put forward to provide additional assistance to the Australian agriculture sector. It is proposed that the Board would contribute to the growth of the sector by providing alternative financial arrangements as well as through research and policy development.
29. The Board's responsibility would involve:
- researching, reporting on and helping to develop the resilience and ongoing financial viability of agriculture and related industries in need of, or potentially in need of reconstruction and development that the Board has identified as being at risk;
 - contributing to the development of Australian agriculture and associated industries and infrastructure by developing and offering financial arrangements and reviewing financial arrangements; and

- reducing or eliminating the impact of financial arrangements that threaten the ongoing viability or sustainability of enterprises in Australian agriculture or associated industries as a result of:
 - : the design of the financial arrangements;
 - : inadequate evaluation of the financial arrangements by any of the parties to the financial arrangements; and
 - : any other adverse circumstances.
30. The Board would then have the power to take whatever action is necessary, as it considers appropriate, to ensure that the RBA gives effect to the policy the Board determines.

CONSIDERATIONS

31. The Board’s proposed remit is broad as it would be required to assist Australian agriculture and related industries.
32. In order to achieve these objectives, the RBA would be involved in providing financial assistance to a wide range of businesses facing financial difficulty. Doing so would likely result in the RBA making large losses on the credit it provides, which could ultimately have negative impacts on government’s fiscal position.
- Under *the Reserve Bank Act*, the Treasurer makes an annual determination about the distribution of the RBA’s net profits, which can be paid to the Government as a dividend.
 - The proposal puts the prospect of receiving dividends from the RBA at jeopardy (Chart 5).

Chart 5: RBA dividend payments to government



Source: RBA

33. In a well-functioning financial system, capital is allocated to more productive sectors in the economy. This boosts overall productivity in the economy leading to higher aggregate output and living standards. Providing support to all industries identified as poorly performing or at risk reduces Australia's growth prospects by encouraging capital to move to weaker sectors of the economy.
34. The proposal notes that the Board would have the task of *"reducing or eliminating the debilitating impact of financial arrangements..."*. The effect of this proposal depends on how the Board achieves this objective.
 - If financial institutions are required to cancel loans and incur a loss, financial institutions will be unwilling to lend to businesses in the scope of the proposed board's remit. This could result in reduced competition in credit provision and encourage industries to become dependent on the government for finance.
 - If the RBA cancels loans and compensates lenders to ensure there is no loss to financial institutions, then lenders could be encouraged to relax lending standards and borrowers would be encouraged to take on excessive debt.
35. An extension of credit to sectors that are indebted and poorly performing is likely to increase that sector's leverage without any necessary improvements in their operation and business conditions.
36. The misallocation of capital directs funding away from other more sustainable businesses, even within the agriculture sector, that have better prospects for contributing to Australia's long-term economic growth.

STATE-OWNED BANKS

37. The proposed Board would be required to provide loans and has similar characteristics to a state-owned bank.
38. The Campbell Committee Inquiry into the financial system (1981) identified the issue of competitive inequality. It was observed that government banks were growing faster than their private counterparts by competing 'unfairly'.
39. More broadly, the Campbell Committee was in favour of increasing the scope for market forces to determine financial market outcome rather than increased participation of government-owned banks.
 - *"In the long-term competitive environment envisaged by the Committee, government-owned deposit-taking institutions should not be needed to fill any important market gap - leaving aside social externalities"*.
40. The RBA was involved in financing the rural sector through Rural Credits Department (RCD) between 1925 and 1988. The Campbell Committee recommended the phasing

out of the program with the view that private markets were well equipped to meet rural financing needs.

41. The privatisation of Commonwealth bank was considered a sensible policy for a bank operating as a commercial enterprise in a market environment.
 - “...it is likely that continued government ownership of the Commonwealth Bank would have opened it up to political exploitation in the 1990s. In economic terms, the privatisation of the Commonwealth Bank was clearly sensible policy” (King 2003).
42. The experience of other jurisdictions with state-owned banks generally finds that the presence of state-owned banks hampers economic growth and distorts the financial system (La Porta et al 2000).
43. Using data from 92 countries on government ownership of banks, La Porta et al 2000 find that government ownership of banks is:
 - particularly significant in countries with low levels of per capita income, underdeveloped financial systems, interventionist and inefficient governments, and poor protection of property rights;
 - associated with slower subsequent financial development; and
 - associated with lower subsequent growth of per capita income, and in particular with lower growth of productivity rather than slower factor accumulation.’
44. Using data from 60 countries, Bath et al 2001 found that greater state ownership of banks tends to be associated with poorer development of banks, non-banks, and securities markets; and that on average, greater state ownership of banks tends to be associated with more poorly operating financial systems.
45. Using cross-country data on a sample of large European banks, Ianotta et al 2012 investigated whether any significant difference exists in the default and operating risk of state-owned banks with respect to private banks. They found that government protection shields state-owned banks from the effects of market discipline and provides them with an incentive to increase risk taking. They also found evidence suggesting that state-owned banks were not undertaking this increased risk order to address market failures and contribute to economic development.
46. Gonzalez-Garcia and Grigoli 2013 found that a larger presence of state-owned banks in the banking system is associated with more credit to the public sector, larger fiscal deficits, higher public debt ratios, and the crowding out of credit to the private sector.
47. Australia’s banking sector is well positioned to serve Australian businesses, reducing the need for a state-owned bank or similar institution.

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