Rural Australia : The Path Forward

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Rural debt Forum Northern Cattle Producers

Diggers Enter Centre

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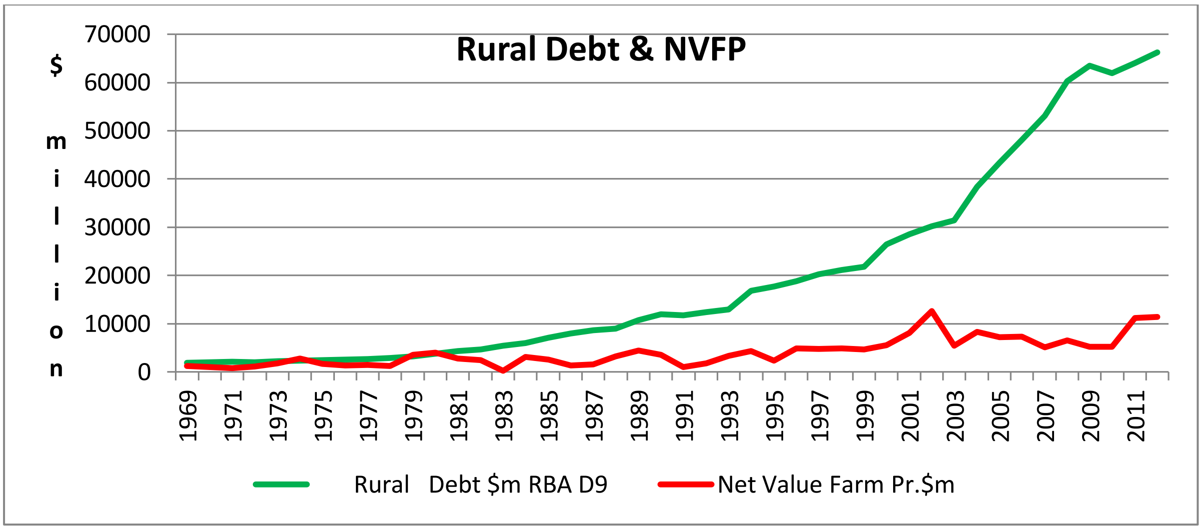

Across Australia, the GFC was the catalyst that exposed protracted long term policy failure. Physical characteristics of policy failure are: low commodity prices, low farm incomes, debt to equity finance, falling land values, bank foreclosures, despair and suicides. For each industry, there is a particular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

This paper outlines the underlying reasons how policy transformed a small farm low income problem of the 1960-70's to become a modern crisis of low income, large farm debt crisis. The paper raises concerns over the competence of rural leadership at all political levels. Publically available data was simply ignored as political ideology maintained a belief that fairies actually did live at the bottom of the free trade garden. The GFC rudely dashed the belief in fairies and exposed crisis of unprecedented debt that threatens the stability of rural Australia, its regions and communities.

The process of asset enhancement is offered as a first step in returning rural Australia to stability and profitability. A second step must follow and that will be a change in direction for rural policy.

Thanks to Roger Crook, WA member of our Round Table Group, for constructive comments on an earlier draft. Responsibility for all errors lies with the author

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1 Introduction; Policy Problem

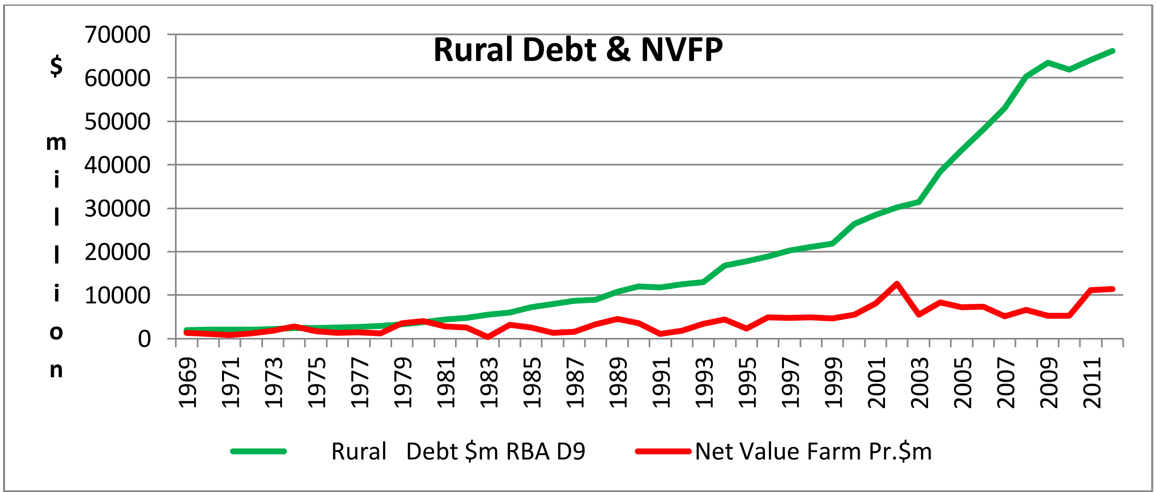
Across Australia, the GFC was the catalyst that exposed protracted long term policy failure. The international financial dislocation from the GFC flowed back to real asset upon which mortgages had been raised. In other words, inflated farm values were written down to more realistic levels. The effect of this was to undermine the solvency of farmers who had borrowed in the halcyon days of debt to equity lending.

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

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

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

Graph 1



Compiled from: NVFP, ABARES Commodity Statistics 2012

Rural Debt RBA Statistics online Table D9

Graph 1 shows graphically the nature and composition of the contemporary rural crisis. NVFP which is an approximation for gross net farm income excluding depreciation has basically flat lined since

1969 to 1991.From then, the curve moves to a marginally higher plateau; but, continues a flat trend line with oscillation around the trend. Meanwhile rural debt rises steadily from 1981 to 1993 when curve assume a life of its own.

The relationship between the two curves shows an empirical unhealthy dependence of NVFP on escalating levels of debt. Such a relationship between debt and income has proven unsustainable over the longer term. Any industry that has debt growing at a faster rate than income over the long term must eventually fail. Rural policy had structured a financial time bomb that awaited a catalyst. That catalyst came in the form of the GST. The linear evidence demonstrates that rural policy had been in a state of failure long before the GST.

Theoretical discussion of policy failure can be found in two papers on my web site above. They were presented at Rural Debt Round Table functions at Merredin WA and Colac Victoria on 15the 16th April 2013[i].

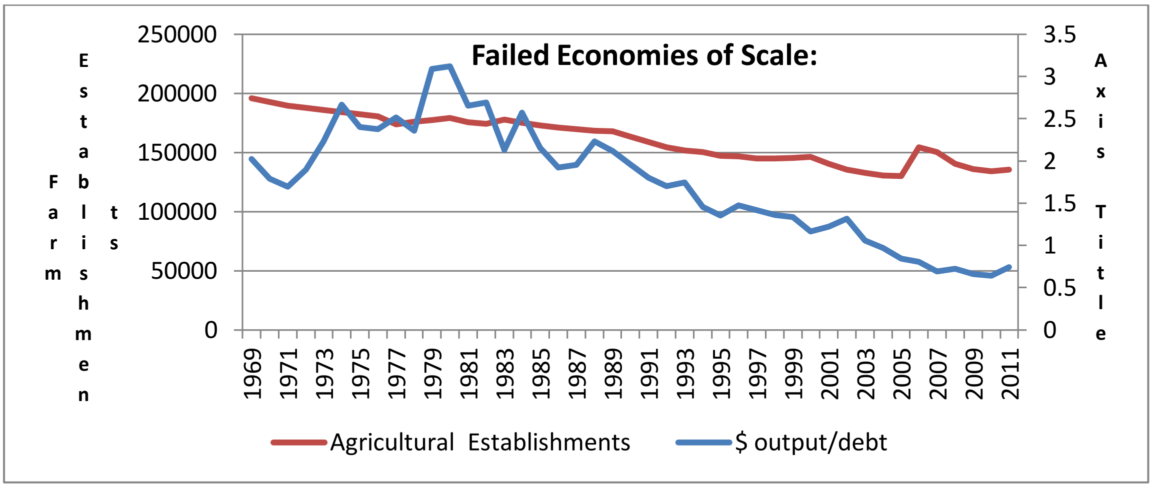
This short paper will outline briefly the problem of farm debt and development of the low income problem; but, the main purpose here is to introduce grass roots agriculture to the process of debt restructure through asset enhancement. Asset enhancement in itself cannot restore profitability; but, it is an essential step towards that policy objective. Once the sector is financially stabilized, policy must seek a new direction to return agriculture to profitability.

2. Structural Reform Failure:

The 1970's witnessed a realization that there was a small farm low income problem in Australian agriculture. This was a worldwide phenomenon in mature economies and produced a number of applied solutions ranging from direct government assistance in other modern economies to Australia's structural reform programs. Australia sought to build a prosperous farming sector through farm amalgamation, economies of scale, and international competitiveness. This policy direction is commonly recognized as "*get big or get out*". I can remember an old timer saying back in the early 1970's, it will probably turn out to be "*get big and get out*".

How fortuitous that comment has proven to be. We now accept that 20% of farmers produce 80% of agricultural output. The debt crisis appears concentrated in the 20% of large farmers who followed the political spin of the policy makers. Concentration of debt among large producers means that policy has transformed the 1970's small farm low income problem into a large farm low income problem. In other words, the policy direction over the past three decades has produced a perverse outcome to that expected.

Graph 2



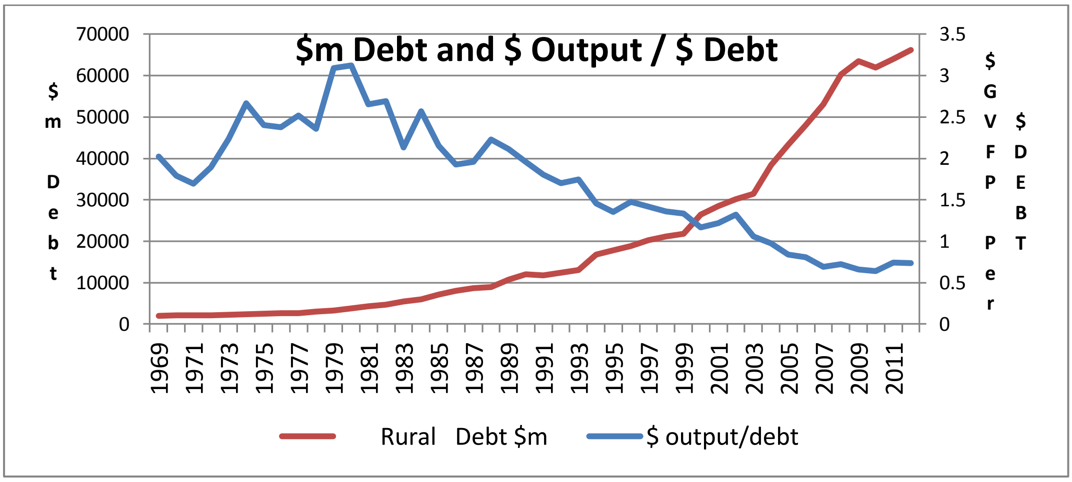
Compiled ABARES 2012, Table 21,

Rural Debt RBA Statistics online Table D9

Graph 2 demonstrates that the dollar value of output supported by debt declines as the number of farm units fall. Whilst some success had been enjoyed prior to 1980, post 1981 that success turned sour. The empirical evidence post 1981 demonstrates the dollar output/debt curve falling more rapidly than the decline in the number of farms establishments. The evidence of these curves reflects badly upon the competence of rural political representation from farm organizations to major political parties.

By 2008-09 when the GFC erupted, the dollar output/debt curve shows a dollar of debt supported an output value of around 70^{C}. Long term policy failure was awaiting a catalyst to trigger major economic dislocation. The GFC obliged.

Graph 3

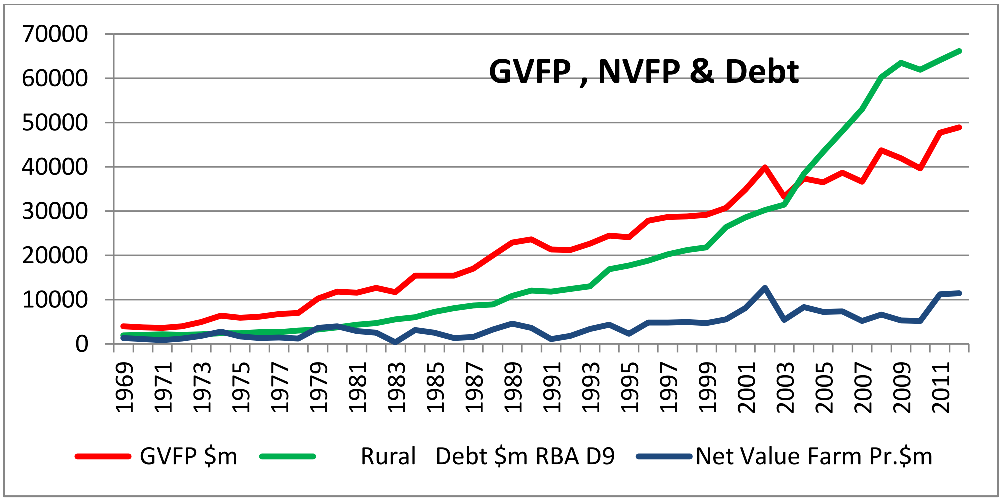


Compiled from ABARES Commodity Statistics 2012 and RBA online Rural Debt Table D9

Graph 3, is critical evidence in the story of policy failure. Political promises that structural reform would produce a viable and profitable rural sector are shown to be a myth. It can be inferred that rising farm debt was unable to lift farm profitability. Again, 1981 becomes an inflection point on both curves as the dollar out/debt curve begins a long downward journey. By 1997, equilibrium between debt and output is reached and each dollar borrowed supports one dollar of output. From 1997 onwards rural Australia is in dire straits yet policy direction does not change. No level of agricultural political representation appears to understand that Australian agriculture could not survive if it continued to borrow to meet the demands of public policy.

4 The erosion of profitability

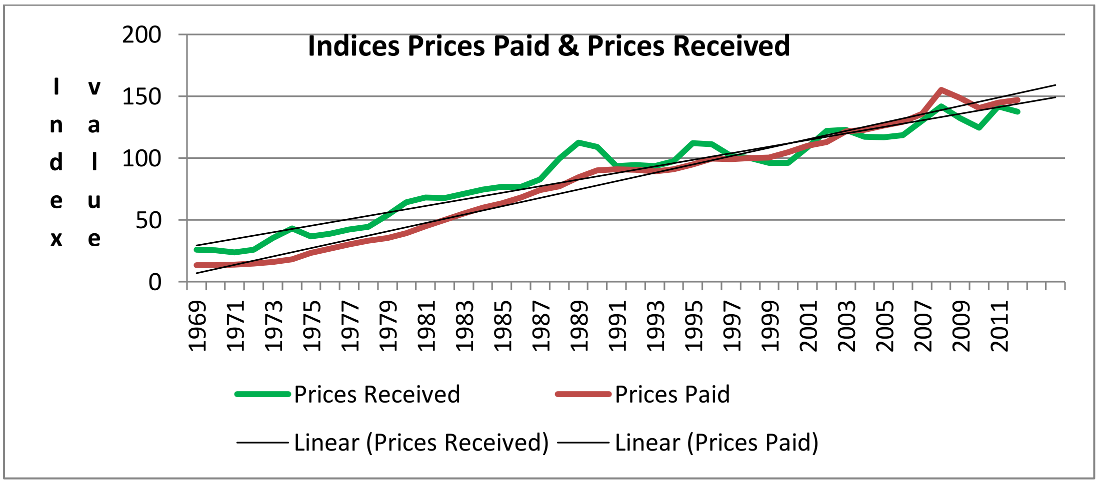
Graph 4



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

Graph 4 delineates the policy dilemma. From the late 1970's growth appears more and more dependent upon debt. The share flowing to farmers represented by NVFP does not benefit from rising growth in GVFP. The debt inflection point is 1979-80. From this point, the wider community begins to benefit at the expense of the farm sector. We see that in 1995, a new plateau is achieved for NVFP; but, rising redistribution from the farm sector to the wider community grinds relentlessly onwards. By 2003-04, debt increases more rapidly than production.

Graph 5



Compiled from ABARES Commodity Statistics 2012 and RBA

Graph 5 provides the empirical evidence that costs (prices Paid) were rapidly closing the gap with prices received from 1981. Costs had actually kicked upwards in 1979. Finally by 1999, trend lines show the cost curve rising above the prices received curve.

The theoretical explanation for this phenomenon is market structure and mal-distribution of market power. Prices received are determined in markets that comprise purely competitive sellers facing monopoly structured buyer markets. Such a hybrid market structure disadvantages purely competitive farmers.

It is the same story with input markets. Inputs are produced under off farm market structures characterized by monopoly power. As the purely competitive farmer has no countervailing power, policy expects improvements in productivity and efficiency to overcome the disadvantage of rising costs. Implicitly, policy assumes productivity and profitability are one and the same. If they were, then it is reasonable to expect a closer reflection of the GVFP curve in the NVFP curve than empirical evidence shows.

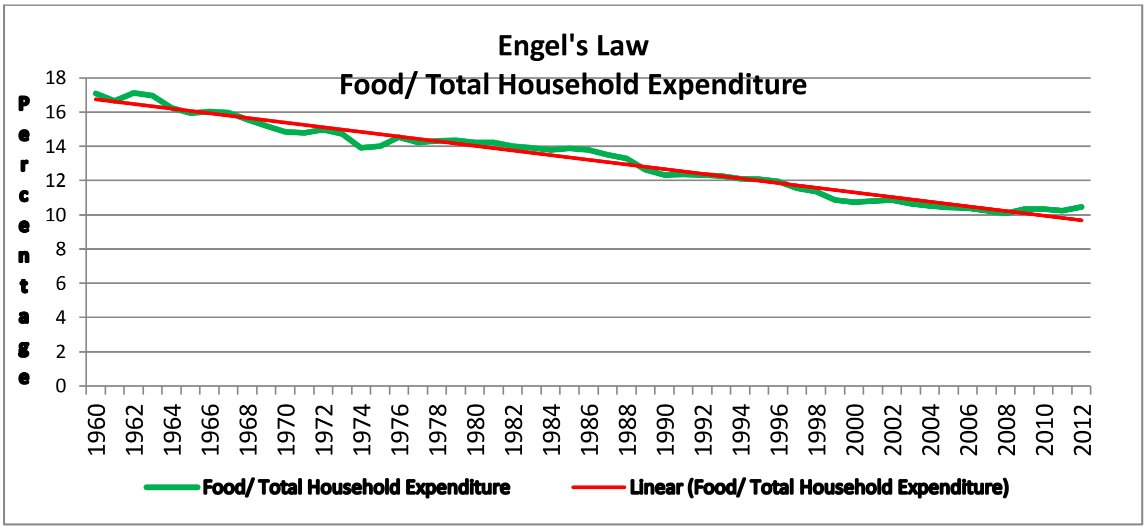
Although orderly marketing in wool and wheat had been removed in the late 1980's early 1990's the introduction of competition policy completed the removal of orderly marketing from late 1990's. Another negative influence on farm costs at that time was the introduction of environmental policy that constrained land use by farmers. The mal-distribution of market power and anti-farm policies such as environmental and competition policy allowed an unrecognized law in economics to come more forcefully into play. That unrelenting law is Engel's Law

Engel's law is discussed at length in the two reference papers on my web site; but, for here it is suffice to say that Engel showed that in growing mature economies, the percentage of income spent on food declines as incomes rise. The solutions to Engel's Law in an advanced economy are three fold:

- Free trade
- Redistribution of income
- A mix of the above two

After three decades of deregulation, international competition and economies of scale, the parlous state of rural Australia would demonstrate that Engel's Law has won out over free trade; and, the political ideology that argued all concerned would benefit as free trade increased employment and lifted living standards both domestically and internationally.

Graph 6



From RBA Occasional Paper No. 8 Table 5.4; and, ABS National Acc. National Income, Expenditure and Product , June 2012, Table 20.

Graph 6 identifies Engel's Law eroding expenditure on food in Australia from 1960 to 2012. What were politicians and rural leaders doing with this type of information on record for all to see?

5 *The Opium of the Politician: Financial Competition*

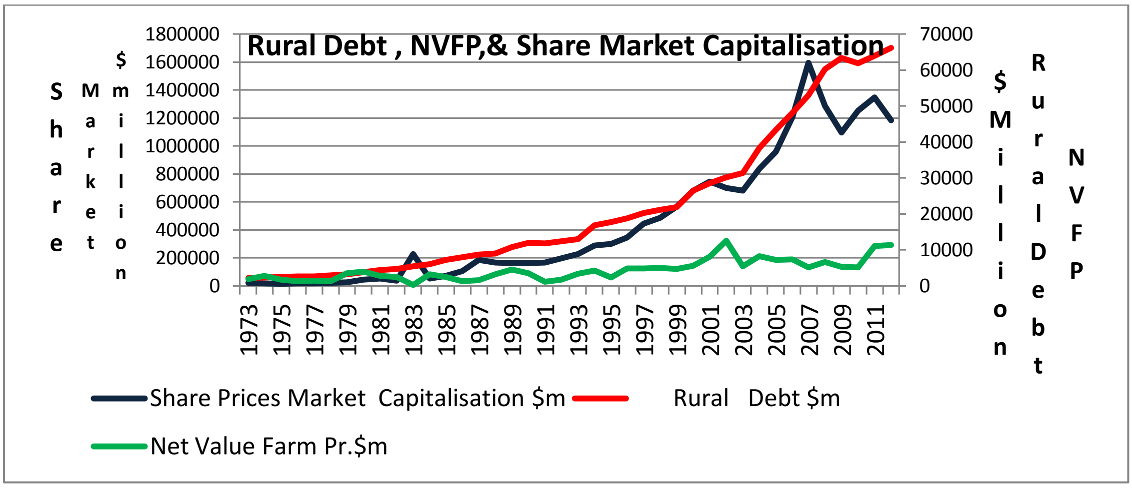
Approach a politician to discuss industry dislocation and the topic is suddenly reshaped to lack of competition in the financial sector. This section will demonstrate that the rural debt crisis is about too much financial competition- not too little.

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

Senate Inquiry 1994[ii]

Originate to Distribute Banking and Securitisation[iii]

Graph 7



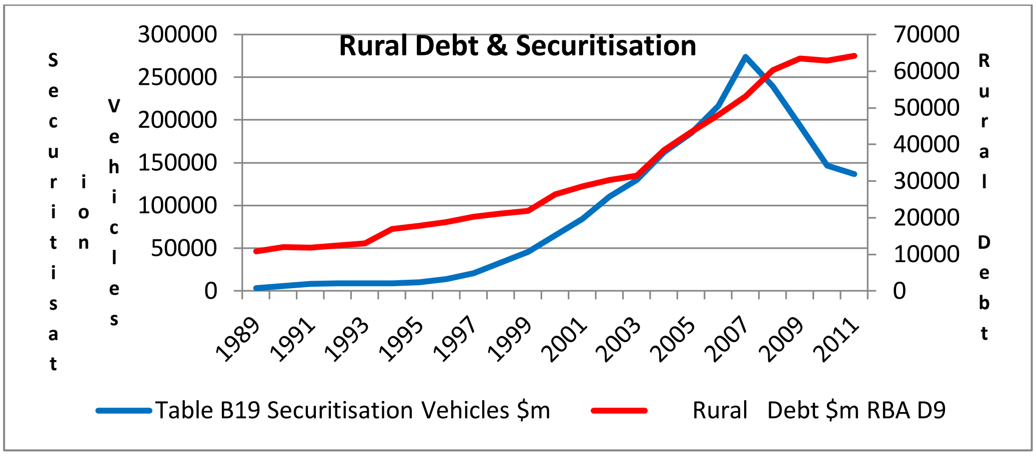
Share market capitalisation from RBA Bulletins 1973-2006 and online, Farm Debt RBA *Table D9, Rural Debt by Lender, online*

From Graph 7, the link between asset inflation and rural lending can be inferred. Rural lending reflects strongly the wider picture of Australian asset inflation. The changed banking model, "Originate to Distribute", made this possible. The "Originate to Distribute" banking phenomena developed during the period of high interest rates under Federal Reserve Chairman Volker over the late 1970's and early 1980's. Unregulated financial institutions could offer higher market interest rates compared to the regulated banking market. Consequently, regulated traditional banking institutions found it difficult to compete for deposits with emerging unregulated money market institutions. Their response was to develop the "originate to distribute" model

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

The emergence of non-performing or "toxic assets" within underlying pools of assets over 2007-08 underwrote the GFC and the subsequent turmoil in international financial markets. Chart 10 illustrates the rapidly expanding growth of securitisation in Australia. Rural debt is overlaid from which it is inferred a growing use of securitisation in rural lending. The collapse in the securitization curve from 2007 provides a rough guide to the level of revaluation that could be expected to flow back to the underlying pools of assets held by the SPV; and, ultimately to the real asset underpinning the process.

Graph 8



Farm Debt: RBA Table D9, Rural Debt by Lender, online, Securitisation: RBA Table B19. Online

Whilst it can be inferred from the linear relationship between rural lending and securitisation, it should be noted that securitisation was not confined to rural finance. For a full discussion refer: RBA Table 19 Notes. Table 19 covers SPV's registered to securitize selected Australian assets which are rated by recognised ratings agencies[iv].

The behaviour of the curves in Graph 8 suggest that securitisation of rural debt began to become an increasingly important feature in rural finance from 1996 onwards. From 2007 onwards, the "originate to distribute" model faced a collapsing demand for securities. The GFC became the catalyst that exposed underlying rural debt as an unsound financial lending practice based upon ever rising land values.

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

For the Australian rural sector, farm market values were under pressure as inflated land prices suddenly became recognised as overvalued. Consequently, market value of farm land fell forcing lenders to examine the capacity of farm income to service debt. Solvency of enterprises funded by equity based borrowing became an issue. Chart 1 demonstrates the futility of such a sudden change in lending practices. Historically, farm income could never service the levels of debt that had been structured on an assumption that land prices would continue to inflate infinitum. When the bubble burst, farmers and their accountants were suddenly faced with the question of managing farm solvency. The rural debt crisis was under way.

In Australia today, the questionable asset becomes farm mortgages experiencing erosion of valuations, unsustainable debt levels, and inadequate income flows. There appears to be some wishful thinking on the part of central bankers that by supporting speculators trading financial instruments somehow the real sector will resume investment and job creation. This is of course a continuation of the failed 1980's-1990's asset inflation growth model. The contemporary asset inflation growth model is not flowing to rural Australia. Farm foreclosures are proof that this model cannot provide a way forward for rural Australia.

The current rural crisis has two strands that must be addressed simultaneously. Firstly, there is the spectre of debt default and farm foreclosures. Simply supporting rural financial institutions with subsidised interest rates will compound resource distortion in rural Australia. The farm financial solution needs to be structured similar to the US Great Depression years. This US model supported both farmers and banks through the difficult times of that period. Eventually, the model proved its worth.

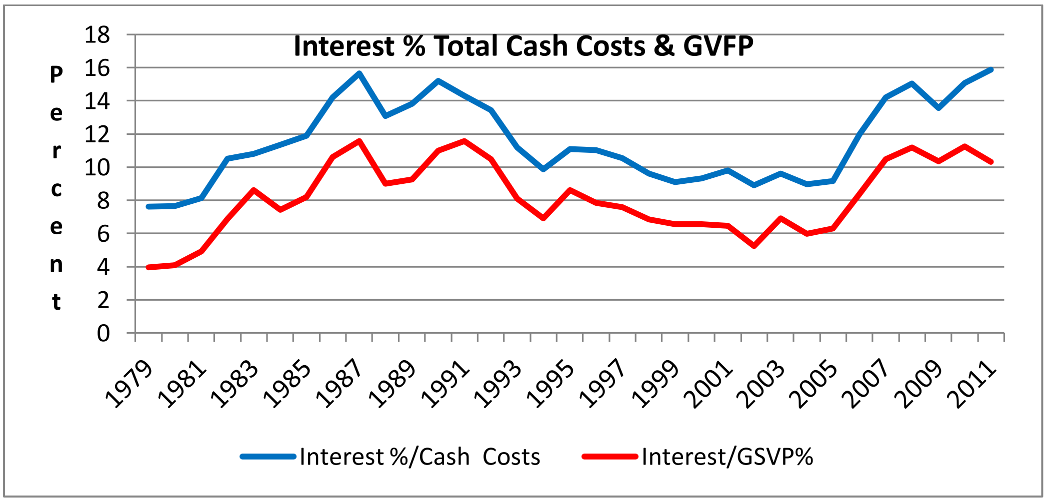
The contemporary asset inflation solution has a fundamental flaw. It deals only with systemic financial dislocation. Nothing is done to address dislocation in the real sector from where the questionable assets originated: the farm sector

6 Interest Impost

The 1994 Senate Inquiry had this to say about the interest impost contribution to the debt crisis then confronting national rural policy.

"The very high interest rates of the 1980's, played a significant role in the development of a debt crisis"[iv]

Graph 9



Compiled from ABARE Agricultural commodity statistics 2011 major components of Australian farm costs & Australian farm returns, costs and prices

Chart 8 shows the 2011 interest impost component of farm costs is higher than in 1990. This time however, interest costs are driven by debt levels rather than the level of interest rates. The similarities of the 1994 Report findings on interest impost have returned to haunt policy makers in 2012. In the 1990's, it was thought competition in financial markets would provide the required solution. Empirical evidence suggests that competition became a policy liability. Finance providers appear more concerned with market share than sound lending practices.

7 A Necessary Step: Asset Enhancement:

"banks, in pursuit of market share in the face of heightened competition, made loans based on security levels offered by existing equity but without sufficient regard to the capacity of clients to repay".

Senate Inquiry 1994[vi]

At the October meeting in Brisbane convened by the then Treasurer Wayne Swan; and, member for Kennedy Bob Katter, the need to establish a fund to address rural debt was conceived. A motion to structure a fund was moved at a meeting hosted by QUT, October 18. The motion was seconded on the grounds that the fund be one of asset enhancement.

Asset enhancement was used as the model to address the US farm debt problem during the Great Depression. The same principle was employed again as Brady Bonds in the international debt default of the 1980's and 1990. The model modified once again came to the rescue in the aftermath of the GFC. The US had TARP, the EU used the European Stability Mechanism, Australia endorsed the concept in principle when the AOFM was instructed to intervene directly and purchase residential back mortgage securities to stabilize the domestic housing debt market; and, consequently domestic home prices. Asset enhancement is a proven model to address a debt crisis and forms the rationale behind our *Australian Rural Reconstruction and Development Board*

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

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

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

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

The establishment of the Australian Reconstruction and Development Board within the RBA is a necessary step; but, by no way completes the task. Once the Senate accepts the Bill, it will enter a committee process. The Senate will call witnesses and seek public submissions. This means the final format of the model will be moulded by the Committee and evidence gathered from witnesses and public submissions. The rural sector must remain vigilant and ensure that ordinary farmers have their say in the Senate process

Once the model and its purpose has been decided through the consultative process, the Bill comes back to the Senate and House of Representatives. In its final form, public servants in the RBA and Treasury will structure the necessary entity to put into effect the legislation emerging from the consultative process. If you are not called as a witness, then make sure you contribute with a written submission setting out your own experiences. It will be the experiences of the farmers and practices of the financial sector that will be of most concern to the legislators.

The second leg of the ARD is the development finance arm. The infrastructure weakness exposed in the recent Graincorp public debate is a typical example of where structured development finance could solve a problem.

Conclusions:

The Australian rural sector is in a parlous situation resulting from ill-conceived structural reform and deliberate government policy of asset inflation to recover from the international dislocation over the 1980's and early 1990's resulting from failure of the US financial system. Discretionary policy of asset inflation fostered imprudent financial sector behaviour that chased market share rather than prudent lending. The GFC exposed imprudent financial practices; but, the consequences have been to erode the solvency of rural producers exposed to inappropriate lending practices of financial institutions. The ARDB is necessary to restructure debt linked to debt to equity lending.

The second step that must be addressed is to change rural policy direction. Engel's Law must form the basis of policy development. Overseas, there appears to be a more mature understanding of the Engel's law phenomenon than in Australia. This thinking must come to Australia and rural producers must engage the wider community in a debate over how the rural sector can share in the fruits of prosperity. The days in which farm leaders could believe in fairies at the end of the free trade garden came to an end with the GFC.

The Australian farm sector has suffered enough and it is time for sensible economics to address the consequences failed rural policy. Change must occur and rural producers and communities must not be reticent in arguing their case.

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

[ii] Senate Rural and Regional Affairs and Transport References Committee, *Rural Adjustment, Rural Debt and rural Reconstruction Report*, Dec. 1994,p.34

[iii] Ibid dec. 2012 and April 2013

[iv] Refer to RBA Bulletin Dec. 2008, Notes Table B19, p. S109

[v] Senate Rural and Regional Affairs and Transport References Committee, *Rural Adjustment, Rural Debt and rural Reconstruction Report*, Dec. 1994,p.34

[vi] Senate Rural and Regional Affairs and Transport References Committee, *Rural Adjustment, Rural Debt and rural Reconstruction Report*, Dec. 1994,p.34