Laura Eadie

Research Director, Sustainable Economy Program

Centre for Policy Development

PO Box K3, Haymarket, NSW, 1240

Re: Submission to the 2014 Financial System Inquiry

The Centre for Policy Development urges the inquiry to consider how well the deregulated financial system works to support Australia's economic stability and growth over the **long-term**, not just the next decade.

The Inquiry should focus on the funding needs for long-term growth and stability of Australia's economy – then consider what institutions, markets and policies are needed to support that – for two reasons:

1. Understanding long-term trends is critical for a major inquiry into the financial system

- The future will not be like the recent past. Global risks are increasing due to the operations of financial markets, and to physical factors such as depletion of natural capital and climate change. For example, commodity price volatility has tripled since 2005.[1] This is a significant change to the operating environment for a commodity export dependent country like Australia.
- Change is unlikely to be linear. The Global Financial Crisis demonstrated disruptive change can occur with little warning. Changes in technology and climate conditions are likely to be similarly abrupt. To navigate a sustainable growth path, Australia needs to think long-term.
- Financial liberalisation can have downsides, which only become apparent over the longer term. Imbalances and biases in the financial system can negatively impact Australia's long-term growth prospects.

2. Financial development of the economy must be carefully managed to avoid downsides

- Monetary policy and prudential policy has a key role to play in managing the influence of the financial services sector on Australia's growth path, in addition to managing financial stability.
- Institutional reform is essential to ensure a focus on the near term does not hold the financial system back from facilitating investment in long-term productive economic gains.

In considering the interplay of the Financial System and the real economy, the inquiry should focus on whether our macro-economic structure is well balanced, our investment in productivity improvement is sufficient, and our management of human and natural capital is adequate to support long-term growth and economic stability.

The following pages explain the above two points in more detail.

1. A LONG-TERM FOCUS IS CRITICAL FOR ANY MAJOR INQUIRY

- The world has changed significantly since the 1981 Campbell and 1997 Wallis inquiries.
- Systemic risks are increasing due to the operations of financial markets and physical factors such as depletion of renewable natural capital and climate change.
- For example, commodity price volatility has tripled since 2005.[2] For agricultural commodities, in particular, volatility is up due to financial speculation, changes in government policies on food reserves, but notably due to extreme weather.[3]
- This represents a significant change to the external operating environment for a commodity export dependent country like Australia.
- While the maturing of Asian countries represents an opportunity to grow value added exports, these markets will be competitive.
- Winners are likely to be those countries with less energy and carbon intensive economies, more reliable production, and skilled and flexible workforces.
- Compared to 30-years ago, Australia's productivity growth has slowed and our economic structure is now more tilted toward bulk commodity products that are forecast to grow slower than global GDP.[4]
- Sustaining Australia's track record of growth will be challenging, unless we make smart decision now.
- This requires long-term investment to unlock new growth industries. Australia needs greater investment in infrastructure, research and development to lift capital and labour productivity, and management of natural capital – such as soil and water – that underpin the promise of agricultural export growth.
- All signs indicate the downside risk of not investing for the long-term may be greater than the risk of doing so.

2. FINANCIAL DEVELOPMENT MUST BE CAREFULLY MANAGED

Monetary policy and prudential policy has a key role

Financial deregulation can undermine long-term economic growth and stability

- A growing literature points to the downsides of financial liberalisation. Two key insights stand out.
- A financial cycle of credit bubbles can drive booms and busts in the real economy.[5] The critical factor is whether credit creation is poorly pinned down by loose perceptions of value and risk, and becomes

unanchored from the real long-term value of assets. Larger and longer cycles have been observed since financial liberalisation began in mature economies in the 1980's.

- Financial development of an economy can either detract from or contribute to growth.[6] The critical factor is the size and pace of expansion of the financial services sector. While a more efficient financial services sector contributes to growth, beyond a certain size the financial services sector can detract from growth as it:
    - competes for resources
    - can misallocate resources, and
    - can create economic vulnerability.
- These two trends play out over multiple decades, not the narrow timeframes generally considered for monetary policy and prudential oversight.
- Australian policy has recognised since the early 2000's that the build-up of financial imbalances masks distortions in real economy, and can lead to deeper downturns if credit growth and asset price increases are not managed.[7,8]
- What is not yet widely recognised is that financial imbalances can distort Australia's economic structure, reduce productivity growth, and deplete the natural capital on which industries depend.
- Given the challenges Australia faces in finding new growth engines there is a critical role for monetary policy and prudential policy in managing financial stability **and** the impact the financial services sector has in keeping the real economy on a sustainable growth path.

Expansion of the financial services may crowd out growth in other economic sectors

- Rapid growth in financial services can reduce the growth of other sectors. A typical financial sector boom can reduce growth rate by ½ per cent per year.[9] Financially dependent and R&D intensive industries are most harmed by financial sector booms.[10]
- Overall productivity growth can suffer after the financial services sector accounts for more than 6.5 per cent of GDP.[11] Australia's sector is over 11 per cent.[12]
- One of the main reasons likely to be an excessive focus on short-term returns, without considering the cost of not investing in long-term productive economic gains.
- We recommend the inquiry look at ways to rebalance shareholder return on investment with long-term value creation.[13,14] This could include buy-side reform of incentives and institutions. On the asset side, it could include reviewing the structure of boards and attention devoted to long-term planning.

Misallocation of resources can reduce productivity

- In Australia, growth in the financial services sector has decoupled from growth in productive assets.

- The rate of productive capital formation has dropped. The Australian financial services sector is now half as efficient as it was 20 years ago at transforming savings into investment in the real economy.[15] In 1990, for every $1 of resources allocated to the finance sector, there was $3.50 of capital formation, but by 2012 that figure had dropped to $1.50 of capital formation for every $1 of resources used.[16]
- This reflects a misallocation of resources that can be seen across the economy. For example:
    - The share of bank assets in (non-productive) property has accelerated beyond business and personal lending.[17]
    - The productivity of mining has dropped as industry has expanded into lower quality resources that cost more to extract.[18]
- In the UK, by comparison, there is growing evidence that the finance industry has generated outsized rents, not through economically productive innovation or competitive advantage but through institutional and market distortions.[19] While evidence of rent extraction is inherently circumstantial, there is macro-level evidence that financial deepening has outpaced the growth of the economy as well as micro-level evidence of excess compensation to the sector, in addition to anecdotal evidence of factors enabling rent extraction. [20]
- While increasing competition within the Australian financial services sector is a worthy goal, it only addresses some of the issues that have led to a drop in productive capital formation.
- We recommend the inquiry look at ways to level the playing field to remove biases toward short-term investment. For example, capital gains tax and negative gearing may provide perverse incentives for short-term or speculative property investment.

Loose perceptions of value and risk can erode natural capital

- Agricultural lending has outpaced production 2-fold since 2001. The ratio of average land price per hectare to total cash receipts per hectare doubled from around 5:1 before 2001–02 to around 9:1 in 2009–10 on broadacre farms. [21]
- This means farm land prices have inflated beyond what farm economics justify – with the risk of widespread default in times of drought. Rural debt now stands at around $66 billion, with an estimated $5 billion of bad debt held by major commercial banks.[22]
- The implications are that farms may be pushed into unsustainable practices to meet interest costs, leading to soil degradation and long-term reduction in productive potential.
- For example, Productivity Commission research shows a clear link between high stocking levels, high feed costs and vulnerability to financial stress during drought.[23]
- We recommend the inquiry take steps to:
    - Identify market failures in financing projects and farming techniques that enhance agriculture's long-term productive capacity.

- Review the adequacy of bank’s loan risk assessment.
- Consider macro-prudential regulation for farm lending.

Institutional reform is essential to re-direct investment toward the long-term

- Australia's long-running infrastructure gap suggests a systemic failure of the financial system to invest in projects that yield long-term productive gains.
- A fundamental problem is the near-term focus of private and public investment, often due to the use of inappropriate discount rates.
- Decisions on discount rate can have significant implications for future economic growth and social welfare.
- A high discount rate implies greater consumption today and less investment for the future.
- It also means discounting future benefits and costs, including those that extend beyond the current generation.
- The result is less investment in projects that have long-term benefits, and a blind-spot when it comes to policies that invest in human or natural capital for future growth.

Capital market myopia holds back private investment

- Empirical research suggests significant evidence of 'short-termism' or 'excess discounting' among UK and US companies over the past few decades.[24]
- For example, one year ahead cash-flows are discounted 5-10% more than would be rational. [25] These effects are more significant in the latter part of the sample, suggesting myopia is increasing over time.
- Australian capital markets are likely to suffer the same short-sightedness, given the global connections between capital markets and common trends in investment advice.

Flawed public economics keeps governments' hands tied

- When considering long-term investments, Australian public institutions refer to market rates of return, with no decline over time.[26,27]
- This contrasts with practice in other developed countries. For example, Australia's Office of Best Practice Regulation recommends a social discount rate of 7 per cent in real terms.[28] This compares to rates of 3 to 5 per cent used in various European countries.[29] The US recommends 2 – 3 per cent for environmental projects, and 7 per cent (with a test at 3 per cent) for other projects. [30]
- Australia's approach reflects several basic mistakes in thinking about public economics, value and risk over the long-term.[31] Three are worth drawing attention to.
- Future consumption depends significantly on some investment decisions made today. This means there is a risk that consuming more in the present leads to a reduction in future consumption. For

climate change and some natural capital, the outcomes of consuming rather than investing could be catastrophic.

- Market prices do not reveal interest rates, or rates of return for collective decisions, over generations. Current markets reveal preferences of individuals and firms for short periods, but do not reveal their preferences for the lives of future generations.
- The prices of natural capital and environmental services[i] are likely to rise compared to other goods as demand increases, or if supply declines due to unsustainable management. Goods with faster growth in value should be discounted at a lower rate.

This leaves an institutional gap in funding long-term economic growth and resilience

- The result is that both capital markets and governments fail to direct investment toward projects that are critical for long-term value creation and economic resilience.
- In a further failure of public policy, governments have a mixed record of creating the markets for such investment, and establishing bridging institutions to overcome obvious market failures.
- This affects not just infrastructure, but also investment in innovation, human capital and natural capital.
- Several stakeholders have made the case for a sovereign wealth fund (SWF) to step into this gap. An SWF is an institutional structure that should be part of a broader discussion about how to achieve macro-economic stability in the face of external risks, and inter-generational equity.
- However, this should not exclude discussion of how other funding vehicles can overcome near-term barriers to investment in Australia's long-term productive growth, and management of human and natural capital.
- We recommend the inquiry:
    - Review the appropriateness of government discount rates used for long-run projects, and for evaluating policies that deplete or restore natural capital.
    - Investigate suitable models for funding vehicles that can overcome public and capital market failures e.g. a natural capital endowment fund tasked with overcoming liquidity or other constraints to investing in projects with identifiable positive returns.
    - Identify ways the financial system can develop products that match long-term interests of superannuation funds with appropriate investments.

---

[i] This includes goods and services produced by natural capital, such as food and fibre. It also includes less tangible services, such as the atmosphere and oceans acting as a sink for carbon pollution.

NOTES

[1] Bernice Lee et al., *Resources Futures: A Chatham House Report*, 2012, 177.

[2] Ibid.

[3] Laura Eadie and Christopher Stone, *Farming Smarter, Not Harder: Securing Our Agricultural Economy*, 2012, 17, http://cpd.org.au/2012/10/farming-smarter-not-harder-2/.

[4] Deloitte Access Economics, *Positioning for Prosperity? Catching the next Wave*, 2013.

[5] Claudio Borio, *The Financial Cycle and Macroeconomics : What Have We Learnt?*, BIS Working Papers, 2012.

[6] Stephen G Cecchetti and Enisse Kharroubi, *Reassessing the Impact of Finance on Growth*, *BIS Working Paper*, 2012.

[77] Frederic S Mishkin, Visiting Scholar, and Reserve Bank, "How Should Central Banks Respond to Asset-Price Bubbles ? The ' Lean ' versus ' Clean ' Debate After the GFC," *RBA Bulletin* no. June quarter (2011): 59–70.

[8] Claudio Borio and Philip Lowe, *Asset Prices , Financial and Monetary Stability : Exploring the Nexus*, BIS Working Paper, 2002.

[9] Stephen G Cecchetti, "Reassessing the Impact of Finance on Growth: Presentation to Bank for International Settlements," n.d., http://www.boi.org.il/deptdata/neumim/neum432h0.pdf.

[10] Ibid.

[11] Stephen G Cecchetti and Enisse Kharroubi, "Reassessing the Impact of Finance on Growth," *BIS Working Paper*, 2012.

[12] Brian Toohey, "Creating More Savings Is Not Necessarily a Good Thing, Says Researcher," *Australian Financial Review*, September 03, 2013.

[13] Dominic Barton, "Capitalism for the Long Term," *Harvard Business Review* March (2011).

[14] Andrew Haldane and Richard Davis, "The Short Long," in *Speech to the 29th Société Universitaire Européene de Recherches Financières Colloquium, Brussels*, 2011, http://www.bankofengland.co.uk/publications/Documents/speeches/2011/speech495.pdf.

[15] Industry Super Assocation, *Finance and Capital Formation in Australia*, 2013, http://www.industrysuperaustralia.com/finance-and-capital-formation-in-australia-australias-financial-system-losing-its-mojo.

[16] Ibid.

[17] David Llewellyn-Smith, "Conflicted Murray Makes Sense on Inquiry," *MacroBusiness*, March 20, 2014, http://www.macrobusiness.com.au/2014/03/conflicted-murray-makes-sense-on-inquriy/.

[18] Arif Syed, Quentin Grafton, and Kaliappa Kalirajan, *Productivity in the Australian Mining Sector*, 2013, https://coombs-forum.crawford.anu.edu.au/sites/default/files/publication/coombs_forum_crawford_anu_edu_au/2013-11/australian-mining-productivity-paper.pdf.

[19] Erick Beinhocker and Tony Dolphin, "Fixing Finance: The Missing Piece in Banking Reform," *Public Policy Research* 19, no. 3 (2012): 166 – 173.

[20] Ibid.

[21] Peter Martin et al., "Farm Performance: Broadacre and Dairy Farms, 2009-10 to 2011-12," *Agricultural Commodities* 2, no. 1 (2012): 160.

[22] Sue Neales, "Rural Debt in Australia Stands at $66bn," *The Australian*, June 18, 2013.

[23] Productivity Commission, *Government Drought Support Productivity Commission, Report No. 46, Final Inquiry Report* (Melbourne, 2009), 136.

[24] Haldane and Davis, "The Short Long."

[25] Haldane and Davis, "The Short Long."

[26] Mark Harrison, *Valuing the Future : The Social Discount Rate in Cost-Benefit Analysis*, Visiting Researcher Paper, 2010.

[27] Infrastructure Australia, *National Public Private Partnership Guidelines - Volume 5: Discount Rate Methdology and Guidance*, vol. 5, 2013.

[28] Harrison, *Valuing the Future : The Social Discount Rate in Cost-Benefit Analysis*, v.

[29] Ibid., 10.

[30] Ibid.

[31] Nicholas Stern, "Presidential Address Imperfections in the Economics of Public Policy, Imperfections in Markets, and Climate Change," *Journal of the European Economic Association* 8, no. 2–3 (April 05, 2010): 276, doi:10.1111/j.1542-4774.2010.tb00504.x.