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committee for economic development of australia

Productivity performance and key issues for financial system reform

This document is based on discussions at the CEDA Council on Economic Policy (CCEP) meeting held 28 March, 2014. It does not necessarily reflect the views or opinions of any individual in attendance unless specifically cited. This summary does not reflect the unanimous views of all participants. Individual views may differ from the statements made in this summary.

Productivity, or the efficiency with which an economy employs resources (such as capital and labour) to produce economic output, has been a constant on CEDA's agenda and has featured prominently in previous CCEP meetings. At the March 2014 CCEP meeting, participants[1] discussed Australia's productivity performance, particularly at the sectoral level. To maintain our standard of living, Australia would require sustained productivity growth of three per cent annually for a decade, an ambitious objective that has never been achieved before. In fact, Australia only achieved three per cent growth for a few years in the 1990s. The task ahead is daunting if we are to maintain prosperity, even for the lucky country.

Improving productivity growth to maintain national prosperity was the focus of CEDA's major research report in 2013 *Australia Adjusting: Optimising national prosperity*. The report puts forward a comprehensive economic reform agenda for an open and adaptive nation to enhance its economic flexibility, improve its capacity to innovate and maximise the potential of its human capital. The recommendations form the basis of a National Productivity Policy (NPP) to drive a sustained improvement to Australia's productivity so that the nation can realise ongoing economic growth. The first section of this summary looks at the productivity issue.

Reform of the financial system is also a key issue that CEDA is exploring, particularly in light of the upcoming Murray inquiry. The second part of this summary looks at the participants' discussion of the key issues associated with the financial system at the moment.

Part I: Breaking down Australia's productivity performance

Since the early 2000s, Australia's productivity growth rates have dropped from the rates experienced in the 1990s. Despite being in our 23rd year of uninterrupted growth, multi-factor productivity (MFP which measures an amount of output given a combination of inputs, usually capital and labour) growth has performed poorly. The year 2012-13 marked the ninth consecutive year of negative or close to zero MFP growth. Further, over the past ten years, Australia has consistently lagged behind the world average when it comes to MFP growth.

A sectoral examination of labour productivity, capital productivity and MFP reveals some differences in performance as shown in Figure 1. Manufacturing's MFP growth has been stagnant, with poor capital productivity growth performance. The mining and utilities sectors have been significant contributors to the decline in productivity growth since the early 2000s, while the financial and insurance services sector have performed well over the period, reflecting the growing importance of the services sector to the long-term prosperity of Australia.

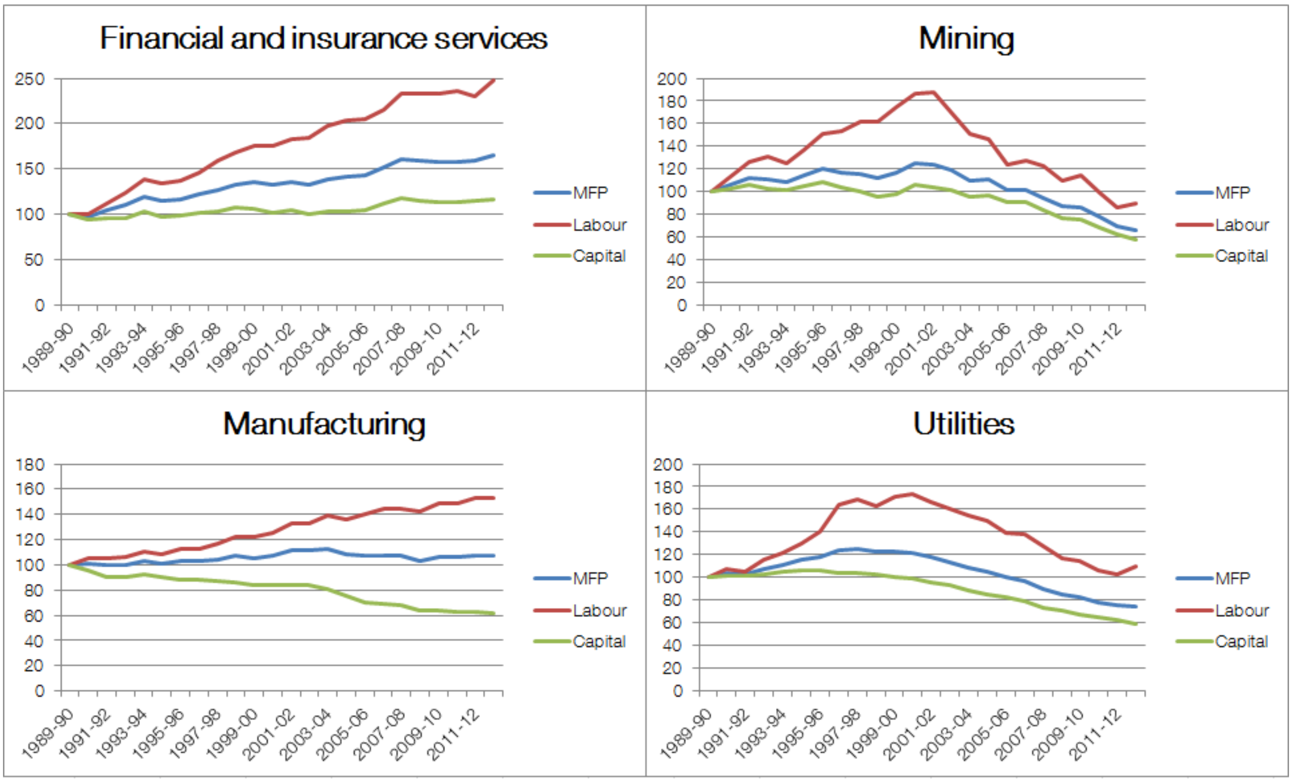

Figure 1: Productivity by sector
Source: ABS. *Estimates of Industry Multifactor Productivity, 2012-13*, Dec 2013.

Productivity performance in the utilities sector

Productivity growth in the non-traded sector has performed poorly over the past decade, as exemplified by the utilities sector in Figure 1. This is in sharp contrast to the 1990s when labour productivity, in particular, was a significant contributor in the utilities and other non-traded sectors of the economy, a direct result of reforms introduced at the time.

The substantial capital investment in the utilities sector (for example, the desalination plant in Victoria) has not been matched by an improvement in output, which has contributed to the drop in productivity. In the electricity sector, in particular, investment is often made for reliability improvement purposes despite overall falling. There is scope for reform, for example, by reviewing the regulatory framework, in particularly, regulator performance.

Productivity performance in the finance sector

The financial and insurance services sector has been a silver lining for productivity performance, particularly for MFP. However, four positive sub-sectors for MFP, namely, wholesaling, retailing, finance and transport, seem unlikely to alter our long-term decline in productivity performance across the board.

In the finance sector, an example of necessary innovation is the ability for elderly Australians to unlock the equity held in their property. This will become increasingly important as the baby boomer cohort begins to retire. The only financial product able to access this equity is the Homesafe approach, which provides debt-free equity release as, unlike reverse mortgages, it is not a loan. Homesafe essentially allows individuals to receive money now for selling part of the future equity in their houses. The question was raised about what, if anything, prohibits the development of more financial products to meet this need.

The finance sector, however, has not been particularly innovative when it comes to infrastructure and infrastructure funding. Canada is overtaking Australia with superior infrastructure financing methods such as project-based bonds, while Australia continues to rely on major banks (and often, a syndicate of banks as no single bank would be willing and able to take on project risk) for major infrastructure projects. Project-based bonds, which reflect innovation in the Canadian finance sector, do not exist in Australia.

In theory, project-based bonds should work in Australia but there are several possible constraints revealed by the differences in the fundamentals of the Australian and Canadian finance sectors. In Canada, superannuation cannot generally be withdrawn as a lump sum; it works as a pension-only scheme. There are other differences such as Canada's proximity to the US and the degree of competition for the supply of funds. However, the most likely explanation for the lack of project-based bonds in Australia is the fact that in Canada, many of the large banks have an investment banking arm while in Australia, none of the major banks ever became investment banks. While this may help to explain why project-based bonds do not exist in Australia, it does not provide a rationale for government intervention for this particular issue.

The insurance market is also interesting as there are numerous insurance products available overseas which are not available to Australian consumers. There is scope for a review to identify why this has not happened and assess the policy framework for the insurance market. However, at this stage, no reviews of the insurance market (be it general or life insurance) have been announced.

Part II: Key issues for the Murray inquiry

Prior to the Murray inquiry, Australia had two financial system inquiries: Campbell inquiry in 1981 and Wallis inquiry in 1997. The trigger for the Campbell inquiry was the fact that banks were not lending enough housing market loans (and were also not lending to women at all). Its successor, the Wallis inquiry, was born out of the failure of the Pyramid Building Society. These inquiries resulted in an institutional structure and a regulatory framework based on a series of assumptions that have since been proven wrong. Yet, we are still using that structure. The much anticipated Murray inquiry will need to look at this issue as well as a series of other themes which participants identified as being crucial. The most significant ones are discussed below.

Superannuation: Superannuation and the associated issues of longevity risk and ageing are crucial. When it comes to superannuation, the key point is to find ways to ensure that funds are channelled in the right place. The trend is that banks will manufacture even more assets for super funds than they currently do (for example, by bundling mortgages off to super funds).

A rethink of superannuation/retirement policy is needed and a starting point would to work out what should be done by regulation, by compulsion and by taxation. We currently require an estimated 16 per cent of income to achieve an appropriate level of savings needed for retirement, a rate that we are not achieving. One of the problems with the current superannuation system is that it is essentially a saving scheme for early retirement and provides incentives to retirees to make risky investments with their lump sums. These issues should be looked at when rethinking superannuation policy.

Regulation: Regulation is also a major issue for the financial system inquiry. In Australia, the regulator, Australian Prudential Regulation Authority (APRA), has been too conservative in setting rules, which has been a disadvantage for our banks, for example when raising money or participating in global markets. The sector is at the mercy of the regulator as it can introduce change and restructure the financial system without anyone being able to object due to the lack of appeal processes. Further, APRA tends to focus on prudence alone to the detriment of other factors such as growth. Unlike the Reserve Bank of Australia (RBA) which has to worry about the trade-off between productivity/growth and stability, APRA has no such trade-offs. These shortcomings could potentially be addressed by folding back APRA into the RBA as their UK counterparts have recently done. There would, granted, be large transitional costs associated with the roll back but there would also be a net benefit.

Trade/international growth: Major changes are needed to allow superannuation funds and the financial system to export. The way Australian funds are taxed when investing overseas needs to change, as was recommended by the Johnson Report in 2010. Presently, Australian funds investing abroad are taxed in Australia and this needs to change to promote trade in the financial sector. Australian banks are also disadvantaged when trying to expand overseas as taking any equity position outside of Australia has to be funded entirely from capital whereas other countries allow funding from both equity and debt.

Funding issues: Ensuring that we have sufficient access to capital to fund our future is not expected to be a major issue given that Australia is likely to become a capital exporter as opposed to being an importer in the future. With a high level of savings and expected fall in investment, there may not be any need to import capital to fund our future as we have done in the past.

When it comes to funding particular sectors, they key issue is to look at what the impediments to investment are. Superannuation funds, for example, face a major impediment as members can withdraw their funds at any time, which is inconsistent with the need to invest funds in riskier and longer-term assets. There are two potential solutions to enable super funds to invest in those types of assets: by reducing consumer choice through limiting when members can withdraw money and through the adoption of a liquidity backstop facility for superannuation funds (such as the RBA does for the banking sector).

Technology: Technology and innovation will have the most impact on the payment system through interconnectivity of payments trends. This is not an issue per se but could be one if the deposit base is not protected. In other words, interconnected people should not become deposit takers. There are some other trends to watch, including bitcoin and institutions providing payment systems despite not holding banking licences, as is happening in the telecommunications sector in Kenya.

Consumer protection: The main challenge for Australian Securities and Investments Commission (ASIC) and Australian Competition and Consumer Commission (ACCC) will be to overcome the cultural issues that clash with the regulatory functions they are meant to perform. They focus on the easier side of consumer protection (e.g. misleading advertisements) but tend to balk at the more complex issues of securities and cartels, issues that deserve to be addressed.

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[1] The following people attended the CCEP meeting on 28 March 2014: Professor Glenn Withers AO (Chair), Geoff Allen AM, Percy Allen AM, Hon Dr Craig Emerson, Professor John Freebairn, Professor Geoffrey Garrett, Tim Harcourt, Professor Ian Harper, Professor Stephen King, Professor the Hon. Stephen Martin, Professor Graeme Samuel AC, Professor Paul Simshauser, Professor Greg Smith, Nathan Taylor, Professor Elizabeth Webster, Sarah-Jane Derby. Professor Ian Harper, Professor Rod Maddock and Peter Harris AO were the presenters.