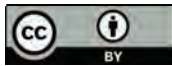


Economic *Roundup*

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Commodity price volatility

Will Devlin, Sarah Woods and Brendan Coates¹

High and volatile commodity prices have returned as a significant global issue, with the prices of many commodities returning to around their mid-2008 peaks. This paper provides an overview of the fundamental drivers of recent price trends and considers the role played by financial speculation in commodity price formation.

It concludes that recent volatility is not without historical precedent. Similar levels of (nominal) price volatility have been observed at various times over the post-war period, particularly during the 1970s. It also concludes that a series of unexpected demand shocks explains most of the variation in commodity prices over recent years.

While it is empirically difficult to completely rule out a causal link between speculation in commodity derivatives markets and short-lived volatility in commodity prices, there are strong grounds to conclude that speculation has not had a systematic impact on recent commodity price dynamics.

¹ This paper was prepared ahead of the G20 Finance Deputies meeting in Paris on 17-18 February. The authors are from Macroeconomic Group, the Australian Treasury. We are grateful for research assistance provided by Cedric Hodges, also of Macroeconomic Group. This article has benefited from comments and suggestions provided by Michael Callaghan, Damien Dunn and Bill Brummitt. The views in this article are those of the authors and not necessarily those of the Australian Treasury.

Introduction

High and volatile commodity prices were a significant global issue over 2007 and into 2008. While the escalating financial crisis over the second half of 2008 – and the precipitous decline in commodity prices that accompanied it – took much of the attention away from the issue for a period, the prices of some commodities have now returned to around their mid-2008 peaks. The causes and consequences of high and volatile commodity prices are again attracting attention.

At their London meeting in September 2009, G20 Finance Ministers and Central Bank Governors committed to ‘work to address excessive commodity price volatility.’ Subsequently, at the Seoul Summit in November 2010, Leaders agreed to continue work ‘to mitigate excessive fossil fuel price volatility’ and identified the need for ‘further work on regulation and supervision of commodity derivatives markets’. France has placed commodity price volatility as a key item on the G20 agenda during its current host year.

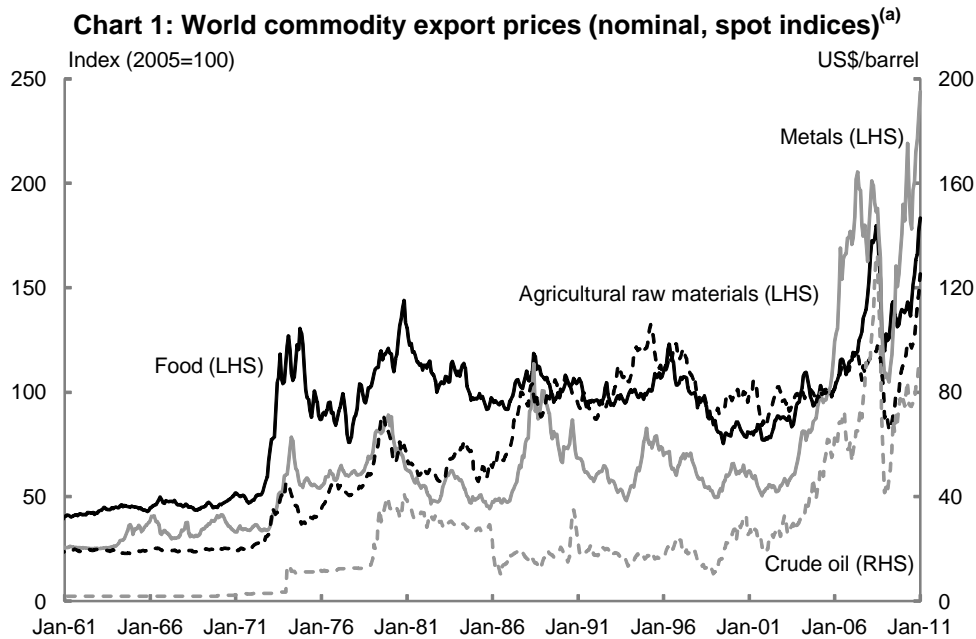
This paper provides some background on commodity price movements. It is divided into four parts. First, a survey of the behaviour of commodity prices over the past decade, and putting this in a historical context. Second, an overview of some of the fundamental drivers of recent price trends, as well as the degree of speculative activity in commodity derivatives markets. Third, a review of the existing empirical evidence on the role played by financial speculation in commodity price formation. Finally, some thoughts on areas where additional work could be undertaken in 2011.

Recent trends in commodity markets

Commodity markets have, at various times, exhibited significant price volatility. The combination of inelastic demand and supply in many commodities means that, at least in the short term, unanticipated changes in demand or supply can generate large price swings.

Beginning in around 2002, commodity markets entered a strong and sustained uptrend. By its peak in mid-2008, this upswing had seen the prices of almost all classes of commodities rise substantially. For many commodities, the pace of price increase accelerated during the period between January 2006 and July 2008 (Chart 1).² The crude oil price, in particular, more than doubled over this relatively brief period.

² In real terms, however, the run-up to mid-2008 only partially reversed a multi-decade decline in commodity prices.



(a) The Agricultural raw materials index is composed of timber, cotton, wool, rubber and hides.
Source: IMF International Financial Statistics.

The speed and magnitude of this run-up in commodity prices is rivalled by only two other episodes in the last century. One was the commodity price boom in the mid-1930s – which was largely a bounce back from the sharp declines seen during the Great Depression – and the other was the price boom in the 1970s.³

During the second half of 2008, commodity prices quickly corrected with the escalating global financial crisis and associated downward revisions to forecasts for global economic growth. From July 2008 to March 2009, commodity prices fell precipitously, reversing most of the gains made over the preceding years. Broad indices of commodity prices reached a trough in March 2009. At a broad level, commodity prices have since recovered more than half of what they lost during the crisis period. Indeed, the prices of some commodities have now surpassed – or close to – their mid-2008 peaks.

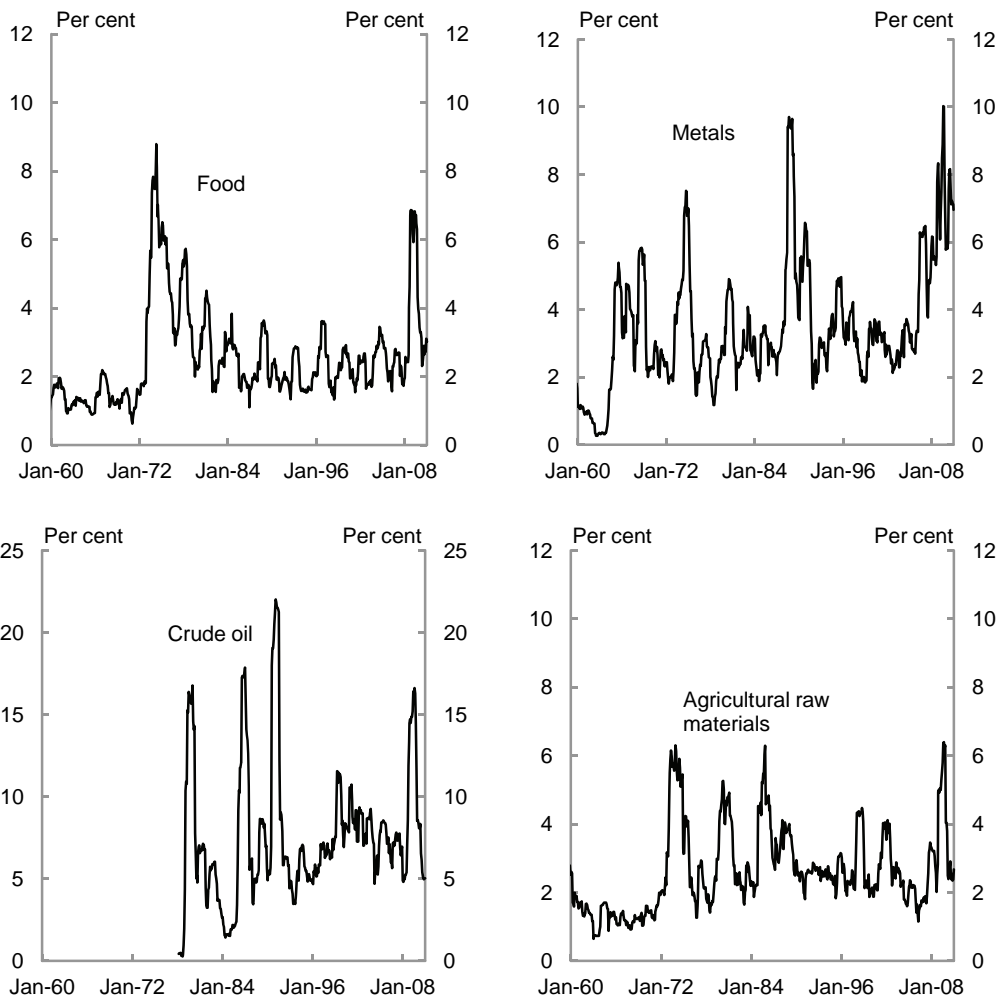
Concurrent with the run-up in commodity prices, volatility in prices has also been elevated over recent years. However, such volatility is not without historical precedent. Similar levels of (nominal) price volatility have been observed at various times over the post-war period, particularly during the 1970s (Chart 2).⁴

³ For a detailed summary, see O'Connor and Orsmond (2007).

⁴ For a more detailed examination of historical volatility in agricultural commodity prices, see OECD (2010).

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Chart 2: World commodity export prices — historical volatility^(a)



(a) Volatility is measured as the standard deviation of month-on-month per cent changes over rolling 12-month windows.

Source: IMF International Financial Statistics.

The fundamental drivers of recent volatility in commodity prices

As in the 1970s, commodity markets have been subject to a number of shocks over the past decade. In contrast to the 1970s, however, the most prominent shocks to hit commodity markets over the past decade have been on the demand side. Led by strong growth in emerging economies, global economic growth averaged 5 per cent per annum between 2004 and 2007 – the strongest four year growth period since the early 1970s. To a significant extent, the strength of the growth impulse from emerging economies was unexpected.⁵

Moreover, this global economic growth cycle was commodity-intensive. Driven by exceptionally strong demand growth from the industrialising economies, particularly China and India, inventories of many major commodities over this period fell to near historically low levels. Commodity demand was also supported by fiscal expansion, an extended period of accommodative monetary policy in key economies and a trend decline in the value of the US dollar (in which most commodities are priced).

Supply side factors were, however, not completely absent from the story. A long period of low and declining commodity prices prior to 2002 had resulted in significant underinvestment in new supply capacity globally – particularly in extractive industries. As a consequence, the supply response to surging commodity prices from 2002 onwards was sluggish, particularly given the typically long delays between investment and production. For agricultural commodities, adverse weather conditions in some key producers, as well as the diversion of some food commodities to the production of biofuels in some countries, were also important. These supply constraints were intensified by policy actions taken by some countries in 2008 to quarantine production for domestic use.

The precipitous decline in commodity prices from mid-2008 was associated with the sharpest collapse in global economic growth in the post-war period. The timing and magnitude of this collapse in growth took commodity markets – and economic forecasters – by surprise. As late as July 2008, for example, the International Monetary Fund (IMF) revised up its forecasts for world growth in both 2008 *and* 2009.

In summary, most of the run-up in commodity prices to mid-2008 can be explained by a series of unexpected demand shocks, combined with a weak supply response. The sharp downturn in global economic activity in the wake of the global financial crisis also explains much of the subsequent decline in commodity prices.

5 For instance, in *World Economic Outlook* publications between April 2005 and July 2007, the IMF consistently upgraded its forecasts for growth in emerging economies.

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A controversial issue is whether speculative activity in related financial markets has also played a meaningful role in influencing the recent movement in commodity prices – the run-up in prices to 2008, and associated increase in price volatility, also coincided with an increase in the prominence of financial investors in commodity markets.

The role of speculation in commodity markets

Speculation in commodity derivatives markets performs a valuable economic function. Firstly, speculation in these markets allows for the transfer of price risk from those least willing to bear it (commodity producers and consumers, or 'end users') to those with the greatest appetite and capacity to do so (generically, 'speculators'). Depending upon where prices are at any given moment, commercial hedgers seeking to buy and those seeking to sell are rarely motivated to do so at the same time. Without the liquidity provided by speculators, end users would be unable to use derivatives markets to effectively hedge their commercial exposures.

Secondly, derivatives markets transmit valuable information about supply and demand conditions. Traders or firms with information about these fundamentals can buy or sell if this information implies that the current price is too low or too high. This informed trading forces prices towards their correct (or, 'true') level. Producers, consumers and inventory holders of the commodity can, in turn, use the information embedded in derivatives prices to make better resource allocation decisions.

The question is not whether speculators can influence movements in commodity prices – clearly they can, and it is desirable for them to be able to do so. Rather, it is whether speculation can force prices to diverge, for any meaningful period of time, from what is justified on a fundamental basis. A more appropriate characterisation of the debate is the scope for commodity markets to be affected by *destabilising* speculation.

Proponents of the view that speculation has played a destabilising role in commodity markets over recent years draw particular attention to the recent growth in index fund investment in commodity derivatives.⁶ The proposition is that the weight of money

⁶ A commodity index fund is a financial product offering investors a synthetic way to take a position in a commodity, or basket of commodities, without ever having to take physical delivery. Commodity index funds arose because most institutional investors do not have access to the sophisticated trading operations necessary to manage a diversified commodity index portfolio using futures contracts. Typically, the approach is to take a long position in a near-term futures contract (referencing some underlying commodity index), sell it a few

flowing into commodity derivatives markets from index funds over recent years – almost all of which was on the long side – drove up futures prices, and with it, the spot price of the underlying physical commodities themselves.

Underlying this argument is the assumption that money flows into futures markets can simply be equated with increasing real demand for the underlying physical commodities. However, futures markets are ‘zero-sum’ markets where all money flows must, by definition, net to zero – for every long position there is a corresponding short position. Theoretically, there is no limit to the number of futures contracts that can be created at a given price level (Irwin and Sanders 2010).

Moreover, the predictability and transparency with which commodity index funds operate raises doubts about the ability of such investors to drive prices away from what would be justified on a fundamental basis. Commodity index funds typically publish in advance their mechanical procedures for rolling to new contract months as well as their desired market weightings whenever the reference index is rebalanced. It is unlikely that other well-capitalised speculators, such as commodity trading advisers, hedge funds, and large floor traders, would allow index funds to push futures prices away from fundamental values when index trades are so transparent and so easily anticipated. Indeed, such sophisticated investors have likened their ability to engage in profitable trades as index funds roll over to new contract months as ‘like taking candy from a baby’ (Irwin et al 2009).

The most intuitively appealing test of whether speculation could push commodities futures prices away from fundamentals and, through arbitrage, spot prices, is to test for a relationship between changes in futures positions held by financial investors and changes in futures prices. The most widely used dataset for performing such a test is the US Commodity Futures Trading Commission’s (CFTC) weekly reports of positions by trader category.⁷ Empirical tests of CFTC positions level data – including by the IMF, OECD and the CFTC itself – have generally not supported the conclusion that the level of speculation in commodity derivatives markets has had a destabilising effect on prices (see, for example, International Monetary Fund 2006a, Irwin and Sanders 2010, US Interagency Taskforce on Commodity Futures Markets 2008). A few studies have also employed daily disaggregated data from the CFTC’s large trader database and have reached the same conclusion (see, for example, Buyuksahin et al 2010, and Aulerich et al 2010).

weeks before expiry, and use the proceeds to take the long position in a subsequent near-term futures contract.

7 The CFTC Commitment of Traders report provides data on futures positions classified by trader group for a range of commodities. This report only provides data on a weekly basis and is highly aggregated.

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The consistency of empirical evidence in this area is compelling, albeit not necessarily definitive. Such an approach relies on being able to accurately distinguish between speculative and hedging activity in a market. In reality, the distinction between hedging and speculation in futures markets is less clear than it may seem. Traditionally, traders with a commercial interest in or an exposure to a physical commodity have been called hedgers (or, commercial traders), while those without a physical position to offset have been called speculators (non-commercial traders). Commercial traders, however, often take a view on the price of a commodity or may not hedge in the futures market despite having an exposure to the commodity – positions that could be regarded as speculative.⁸

Similarly, there is some empirical ambiguity over the extent to which fundamental dynamics can fully explain movements in commodity prices over the past decade. At any given time, of course, the true (or, correct) price of a given commodity is unobservable. Correctly identifying all the factors influencing commodity prices, including the role played by expectations of future supply and demand fundamentals, means that such a modelling approach is not straightforward and fraught with uncertainty. Moreover, assuming it is possible to identify those fundamental price determinants, such an approach relies on being able to measure changes in those factors accurately – the quality and reliability of data is a significant problem in some commodity markets.

Nevertheless, there are grounds to conclude that the level of speculation in commodity derivatives markets has not had a systematic influence on commodity prices. One of the most compelling is that the prices of commodities without actively traded derivatives markets (such as LNG, coal and iron ore, among others) appreciated at least as strongly during the run-up to mid-2008 as commodities with active derivatives markets. If speculation in commodity derivatives markets was driving prices above what was justified, one would expect to have seen larger price increases in those markets with actively traded derivatives markets. This was not the case in the run up to mid-2008, nor has it been the case in the most recent experience of rising commodity prices.

A related observation is that, if speculation in commodity derivatives was having a significant price effect, there should be a weakening in the historical correlation between spot prices in those markets with and without active derivatives markets. In fact, historical correlations between spot prices for commodities with active

⁸ Energy trading desks within airline companies, for instance, are classified as hedgers, even though they often trade for the purposes of making speculative profits.

derivatives markets and those without have not weakened in recent years as speculative activity has risen.⁹

In addition, price movements across commodities are not synchronised. For example, whereas the prices of some commodities (such as iron ore and some agricultural commodities) have returned to levels around their mid-2008 peaks, the prices of several other commodities (such as crude oil, LNG and rice) remain significantly below their previous peaks. Some commodities (such as copper, sugar and cotton) have gone well beyond their previous peaks. While commodities have many common macro drivers, this asynchronous behaviour shows that they are responding to their own unique supply and demand dynamics.

Finally, one of the key signatures of a speculative bubble in a market for a storable commodity is an accumulation in physical stocks (inventories). If financial speculation in commodity derivatives was driving prices above the levels required to equilibrate demand and supply for the underlying commodity, then this would be evidenced by an inventory build, or production would have to be reduced to compensate. Notwithstanding concerns over the reliability of some commodity market data, there is little evidence to suggest that physical hoarding accompanied the large run-up in the prices of storable commodities to mid-2008. For example, inventories of many agricultural commodities actually declined over most of that period, while inventories of other commodities such as crude oil were flat.¹⁰

Some issues to explore

While it is empirically difficult to completely rule out a role for speculation in commodity derivatives markets to increase price volatility, there are strong grounds to conclude that speculation has not had a systematic impact on recent commodity price dynamics. At best, the issue is whether speculative activity can have a modest and short-lived influence on commodity prices and, even at that level, the evidence is far from conclusive. Moreover, speculation in these markets performs a valuable economic function.

There are, however, a number of areas where the functioning of commodity markets could be improved.

As a first step, there would be merit in developing a deeper understanding of the interaction between physical and financial markets for commodities. Towards this end

9 For example, Korniotis (2009) showed that the co-movement between metals prices with and without futures contracts has not weakened in recent years as speculative activity has risen.

10 See, for example, International Energy Agency (2008).

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the International Energy Agency (IEA), the International Energy Forum (IEF) and the Organisation of the Petroleum Exporting Countries (OPEC) has a work program aimed at improving the understanding of the linkages between the physical and financial markets for energy. This work could be extended – via an appropriate forum – to encompass all commodity markets, including agricultural commodities.

Improving the quality and timeliness of data on physical market fundamentals is an important step towards addressing price volatility. Price volatility in commodity markets is intimately linked to uncertainty. The lack of timely and comprehensive physical market data – particularly in non-OECD countries – continues to hamper the efficient functioning of both physical commodity markets and related financial markets. To date, the G20 has endorsed and supported the work of the IEF on improving data quality and transparency in oil markets – via its Joint Oil Data Initiative (JODI). There is much scope for relevant international organisations to pursue similar data initiatives in the non-oil commodities space.

Improving transparency in the markets for commodity derivatives – particularly those traded over-the-counter (OTC) – is important. Commodity derivatives markets, in some circumstances, can be susceptible to deliberate manipulation. Manipulation in derivatives markets can make prices excessively volatile and reduce their informational content, and cause costly distortions in physical commodity markets. Indeed, deterring market manipulation is the primary objective of derivatives market regulations in most jurisdictions. Yet, the ability of market authorities to adequately detect and combat market abuse has been limited by the almost complete absence of transparency in OTC derivatives markets.

The Financial Stability Board's (FSB) Working Group on OTC Derivatives has provided recommendations to significantly improve the transparency and oversight of OTC derivatives markets, including those referencing commodities. Among the FSB's recommendations is that '[A]uthorities must require market participants to report all OTC derivatives transactions ... in a timely manner to trade repositories'. Trade repositories can significantly increase the transparency of positions in OTC markets. The International Organisation of Securities Commission's (IOSCO) Task Force on Commodity Futures Markets has been working with major market participants exploring the case for a trade repository for commodity derivatives.

Finally, work should be directed at removing domestic policy distortions in physical commodity markets, particularly in agricultural commodity markets. Policy settings designed to alter the prices paid or received by domestic consumers or producers – by distorting the incentives producers and consumers face to increase or decrease consumption or production – cause international prices to fluctuate to a much greater degree than would otherwise be the case. Indeed, the IMF has highlighted research showing that volatility in world food prices could be substantially reduced if all

countries ceased to insulate their domestic markets (IMF 2006b). Ensuring free, fair and open access to global commodity markets is therefore critical, both for smoothing commodity price volatility and for achieving the twin goal of improving global food security.

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The Australian banking system — challenges in the post global financial crisis environment

Dr Ken Henry, AC¹

The following is a speech by Dr Ken Henry to the Australasian Finance and Banking Conference presented on 15 December 2010. The speech makes some observations on the structural challenges facing the banking industry. These observations are framed by a set of trends in a number of areas including: the role of the banking system in funding the current account deficit; aggregate credit growth; the composition of bank funding and developments in the residential mortgage backed securities market; the cost of bank funding; movements in the net interest margin of the banking system; bank profitability; and competitive dynamics in the banking sector.

¹ The author was the former Secretary of the Australian Treasury, from April 2001 to March 2011.

Introduction

Good morning.

Thank you for giving me the opportunity to share my thoughts on recent developments in Australia's banking sector. Banking is a topical matter amongst policy makers, industry participants and the community generally.

That level of interest partly reflects the fact that the competitive dynamics in the industry have undergone substantial change in recent years. It also reflects concerns about rising interest rates and views about appropriate levels of profitability of the industry. While we, in Australia, are debating these matters, it is the continuing instability of the banking system that is of prime interest in most other advanced countries.

Notwithstanding its proven robustness, the Australian banking system is facing its own challenges in the post global financial crisis (GFC) environment. These challenges must be of interest to policy makers focussed on enhancing consumer welfare.

In this post-GFC environment, those interested in banking policy are grappling with issues relating to the trade off between:

- on the one hand, a regulatory framework that ensures that the banking system is safe and stable; and
- on the other, a case for policy adjustments to stimulate competitive pressures in the industry.

A safe, stable and competitive banking system is critically important for community wellbeing, given the role it plays in people's lives and in the economic fortunes of the nation.

The importance of a safe and stable banking system for sustainable economic growth was brought into sharp focus in the crisis of 2007 and 2008.

Countries with weak banking systems experienced a severe downturn in economic activity in the following period. Notable examples are the United States and the United Kingdom. As these examples are illustrating, economic downturns associated with financial crises tend to be more severe and prolonged.

The Australian banks, on the other hand, are well-capitalised and highly-rated. I think it is safe to conclude, now, that they have benefited from years of rigorous supervision by better than world-class financial regulators. That quality of supervision is no

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accident. An important feature of our regulatory infrastructure, for many years, has been a common understanding between governments, the regulators and the regulated of the importance of prudential regulation.

Australian banks have not collapsed. No banking firm needed to be bailed out with taxpayers' money.

The Australian banking system has emerged from the GFC in a stronger position, relative to banking systems in many other countries. For good reason, it is highly regarded around the world.

Yet, as I have said, the Australian banking system is facing significant structural challenges in this post-GFC environment.

One such challenge concerns the banking system's capacity to raise funding on cost competitive terms in an environment of continuing volatility in offshore markets, particularly in Europe, and the subdued recovery in the domestic securitisation market following a severe disruption during the GFC.

A second challenge is to foster a competitive banking environment for consumers of banking services, particularly at the retail level, in an industry that has become more concentrated as a result of the crisis.

And a third challenge is to implement the G20's international regulatory response to the GFC. This response is designed to strengthen the global banking sector, taking heed of the lessons learned from the GFC. The challenge for us is to implement the G20 regulatory reforms while taking account of Australia's unique circumstances and avoiding unhelpful impacts on credit flows to the economy.

Today, I want to make some observations on these structural challenges facing the industry. My observations will be framed by a set of trends in a number of areas relevant to system performance, including:

- the banking system's role in funding the current account deficit;
- aggregate credit growth;
- the composition of bank funding and developments in the residential mortgage backed securities market;
- the cost of bank funding;
- movements in the net interest margin of the banking system;

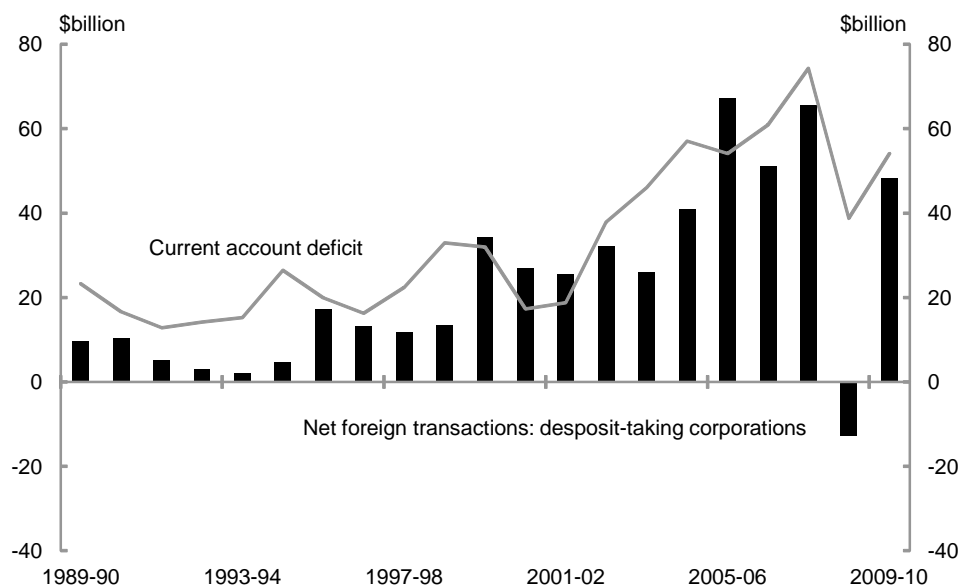
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- bank profitability; and
- competitive dynamics in the banking sector.

Funding the current account deficit

A structural characteristic of the Australian economy is that domestic investment exceeds domestic saving. This gap is the current account deficit. Our current account deficit is strongly correlated with off-shore borrowings by the Australian banking industry, suggesting that the banks play a major role in financing the nation's excess of investment over domestic saving (Chart 1).

Chart 1: Funding the current deficit



Source: ABS cat. no. 5302.0.

2008-09 — the year of the GFC — was an exceptional year. In that year, the banking sector unwound a small part of its offshore liabilities and the financing of the current account deficit relied to a much greater degree upon equity flows and the Australian corporate sector.

The fact that the banks have intermediated such large flows of off-shore funding for such a long period of time suggests that those undertaking real investment activity have found this source of funding attractive. Borrowing costs have been lower than otherwise. And refinancing risk has generally been considered low.

But the GFC has tested these assessments, serving as a reminder that their validity rests on foreign investors remaining confident that Australian banks are stable and well-regulated, and are able to service what they borrow.

Aggregate credit growth

Another characteristic of the Australian economy over the past 25 years or so is that growth in credit has vastly exceeded the growth of gross domestic product. Aggregate credit expanded from around 50 per cent of gross domestic product in the mid-1980s to around 150 per cent of gross domestic product in the late 2000s.

This growth reflected a significant increase in credit demand, particularly from the household sector, with annual credit growth averaging 15 per cent. This increase in demand was accommodated by new participants, such as foreign banks in the mid-1980s and the emergence of mortgage originators in the mid-1990s; more diverse products; and some easing in lending standards.

In the last three years or so, though, growth in credit has been a little slower than GDP growth. While growth in credit to the household sector has continued to exceed GDP growth, though not by as big a margin as in the previous two decades, growth in business credit has been significantly lower than GDP growth.

This levelling out in credit growth means that the banking system's funding task has eased, but it provides no grounds for complacency – especially given ongoing volatility in offshore financial markets.

Composition of bank funding

Relative to the period prior to the GFC, there has been increased reliance on raising deposits and on longer term wholesale funding (including sourced from offshore markets), with less reliance on short term wholesale funding and securitisation products (particularly RMBS).

These developments partly reflect a reassessment of risk in the post-GFC environment. They are also in anticipation of regulatory change in the post-GFC environment, including new international standards on bank liquidity to be fully implemented by 2015.

The greater reliance on deposit and long term wholesale funding, and less reliance on short term wholesale funding, enhances the stability of the Australian banking system. If sustained, it should enable the system to better withstand any future international liquidity shock.

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The Australian Government supported the funding of the banking system during the GFC with the introduction in October 2008 of the Guarantee Scheme for Large Deposits and Wholesale Funding.

These guarantees provided the banks continued access to funds on competitive terms during the turmoil. They were critical in supporting the continued flow of credit.

The Guarantee Scheme for Large Deposits and Wholesale Funding was removed with effect from 31 March 2010.

Even in this more stable environment, the banking system will face a challenge in rolling over 'on cost competitive terms' around \$130 billion in guaranteed debt in the period 2011 to 2014. The Government's measure, announced on the weekend, of allowing banks, credit unions and building societies to issue covered bonds should assist in this funding task, supporting the robustness of the banking sector over the medium to long term.

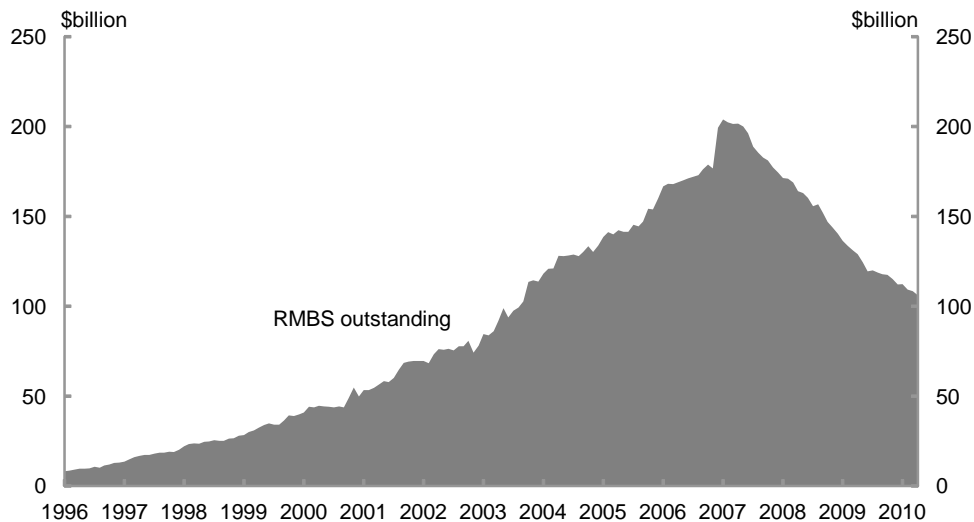
Residential mortgage backed securities market

Another development relevant to system performance is the sharp contraction of the residential mortgage back securities (or RMBS) market. This has had its greatest impact on the smaller banks and non-bank lenders.

In the period up to mid-2007, net issuance of RMBS expanded rapidly. This expansion made a significant contribution to the funding of aggregate credit growth, and provided stimulus to competition in the home loan market by enabling the smaller banks and non-bank lenders to access funding on competitive terms.

In the post-crisis environment, the RMBS market has subtracted from credit growth (Chart 2). During this period, the Government has chosen to support the RMBS market through the Australian Office of Financial Management (AOFM). To date, these investments have supported around \$26 billion of RMBS issuance.

Chart 2: Australian RMBS outstanding



Source: RBA.

It is clear that the GFC has badly damaged investor confidence in securitised housing products globally (particularly in the United States), even though the Australian RMBS product continues to perform well as an investment. While a recovery in the RMBS market is clearly evident, it has been subdued.

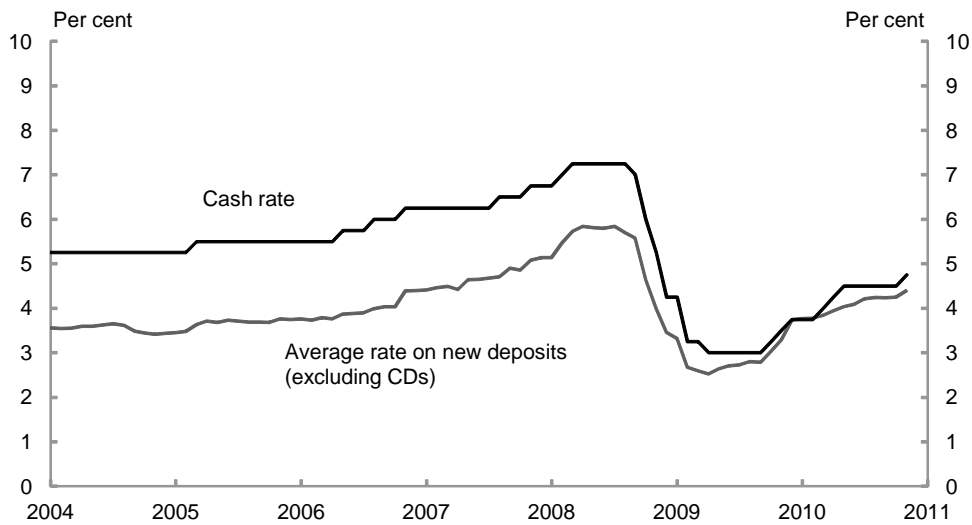
For that reason, the Government announced on the weekend that it would continue to support the RMBS market with a new \$4 billion tranche of purchases from the AOFM. The Government will also explore options to facilitate the issuance of RMBS structured as 'bullet securities' where the principal is repaid on maturity of the security rather than in an amortised form in the current 'flow-through' structure. The Government has been advised that a bullet structure for RMBS will attract a broader base of potential investors.

These RMBS measures support second tier lenders especially.

Cost of funding

I noted earlier that competition for deposits has intensified since mid-2008. This competition has seen a significant increase in deposit rates relative to market benchmarks (Chart 3). The intensification of competition is most noticeable in term deposits. It has occurred notwithstanding increased concentration in the banking sector post-crisis.

Chart 3: Major bank deposit rates relative to the RBA cash rate



Source: Major banks' financial reports and Treasury.

The RBA estimates that the average cost of major bank's new deposits is currently only slightly below the cash rate, having been around 150 basis points below the cash rate prior to the onset of the GFC.

While net savers, such as self funded retirees, are benefitting from increased returns on deposits, higher deposit interest rates have contributed to upward pressure on lending rates relative to the cash rate.

Bank wholesale funding has also been more expensive. Wholesale funding excluding RMBS represents about 40 per cent of the funding of the major banks and about 30 per cent for the second tier banks.

Spreads for the major banks relative to the risk free government benchmarks in both onshore and offshore markets increased from an average of around 50 basis points during 2006 and 2007 to between 200 and 280 basis points during the GFC. They have since fallen to around 120 basis points, remaining well above pre-GFC levels.

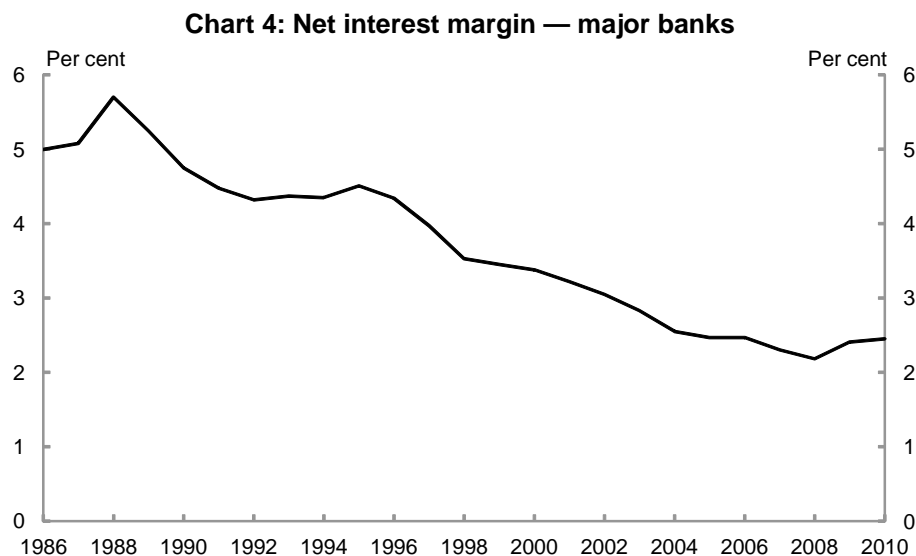
While this change has impacted Australian banks, many other jurisdictions were more heavily affected by the repricing of risk.

Post-GFC, the price of credit has adjusted to better reflect fundamentals. Thus, some part of the repricing should be considered permanent. There probably has been a structural change in the relationship between bank funding costs and benchmarks such as the official cash rate.

Net interest margin

The overall impact of these developments is reflected in the so-called net interest margin. So too is the level of competition. Where competition is increasing, net interest margins will fall, all else being equal.

Net interest margins of the major banks fell from slightly below 6 percentage points in the mid 1980s to a low of around $2\frac{1}{4}$ percentage points in 2008, immediately before the crisis (Chart 4).



Source: RBA.

The sustained downward pressure on the net interest margin is one of the clearest, long-term economy-wide benefits of the deregulation of the Australian financial system, including the removal in 1986 of the regulatory interest rate cap on housing loans provided by the banking sector. Households and businesses have been the primary beneficiaries of this downward movement in the net interest margin.

Competitive pressures from non-prudentially regulated lenders and new bank entrants in the period since around 1995 also played an important role in the fall in the net interest margin. New technologies that permitted a lowering of the industry's operational costs would also have played a part.

Over the last two years, the net interest margin has increased from $2\frac{1}{4}$ percentage points to $2\frac{1}{2}$ percentage points — back to 2005 or 2006 levels.

It is too early to judge whether this post-GFC widening can be explained fully by a lessening of competition, but it does provide a case for close examination of the factors

affecting competition. The net interest margin needs to be sufficient to absorb bank operational costs and bad debt expenses over the course of an economic cycle, and then to provide a return to bank shareholders on their investment. Thus, the net interest margin will be affected by perceptions of default risk, among other things. But it is doubtful that a rising probability of asset impairment explains the recent increase in the net interest margin. Asset impairment has probably been lower than would have been expected a couple of years ago.

In contrast to the major banks, the net interest margin for the second-tier banks has generally fallen since the onset of the crisis. Some of this margin compression reflects that the regional banks have incurred a larger increase in their funding costs.

But it is also the case that the second-tier banks' business lending portfolios are small relative to their mortgage portfolios, and mortgage lending in Australia is usually considered significantly less risky than business lending, even during an economic downturn.

Further small reductions in net interest margins over time are likely, bearing in mind the importance of ensuring that the industry does not become exposed to the sorts of stability issues that affected many countries during the recent crisis.

Bank profitability

The profitability of the Australian banking sector gets a lot of attention.

Since 1992 it has recorded a post tax return on equity of around 15 per cent. This is similar to the return of other major companies listed in the Australian Stock Exchange as well as banks in other countries prior to the GFC.

Is a 15 per cent post-tax rate of return on equity too high or too low? One way of answering that question is to say that it cannot be regarded as too high if the industry is sufficiently competitive; if the provision of banking services is sufficiently contestable. And that is one reason why there is so much focus on banking competition.

Competitive dynamics in the banking sector

The Treasury presentation earlier in the week to the Senate inquiry on competition in the banking sector drew attention to a number of significant developments which have, collectively, altered the competitive dynamics of the retail banking sector in recent years.

The Australian banking system — challenges in the post global financial crisis environment

The first, mentioned earlier, has been the subdued recovery in the RMBS market. This has adversely affected the ability of smaller market participants to raise funding at competitive prices, in turn reducing their capacity to compete against the major banks in the home lending market.

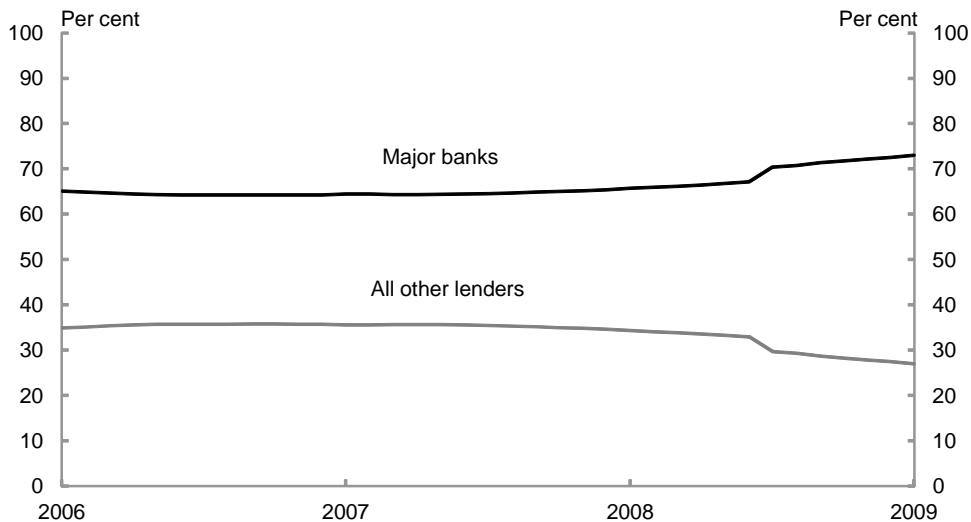
The second development affecting competition is foreign banks either withdrawing or scaling back their Australian operations, reflecting their reduced capacity to raise funds and to deploy capital away from their home operations.

And thirdly, there has been further consolidation in the Australian banking sector since the global financial crisis.

A consequence of these factors is that the four major banks have expanded their collective market share across a range of loan and deposit products.

This is illustrated in the home loan market (Chart 5). The share of total housing loan credit for the five largest banks — the four majors plus St George — has increased from around 60 per cent before the onset of the GFC in mid-2007 to around 73 per cent.

Chart 5: Major banks gain market share



Source: RBA.

Increasing concentration in the home loan market is not conclusive evidence of a lessening of competition in this segment of the banking sector. Nor, as I said earlier, is the fact of interest rates on home loan products increasing by amounts in excess of movements in the RBA's cash rate.

Yet there is no question that the competitive dynamics in the home loan market as a result of the crisis and the downturn in RMBS issuance.

The Australian banking system — challenges in the post global financial crisis environment

This may not necessarily mean a lessening of competition in the home loan market. The re-pricing of home loans and other lending products could simply be a response to changes in funding costs and a re-assessment of risk.

As far as market interest rates are concerned, the Governor of the Reserve Bank of Australia has publically stated that the Reserve Bank Board has taken into account, and will continue to take, changes in the pricing of lending products into account in its monetary policy decisions.

Thus, calls for the Government to regulate lending rates on particular bank products are quite peculiar.

The only certain outcome of any such regulatory intervention would be credit rationing, with some households and businesses finding it impossible to access credit on reasonable terms. Typically, such interventions have unsavoury distributional consequences — for obvious reasons.

The Government is seeking to enhance competitive pressures in the provision of retail banking products, including home loans, with the package of measures announced on the weekend. This includes:

- banning exit fees on new home loans;
- examining providing a capacity for consumers to transfer deposits and mortgages between banks;
- enhancing disclosure of home loan products;
- supporting credit unions and building societies;
- empowering the ACCC to investigate and prosecute anti-competitive price signalling;
- fast-tracking reforms to credit cards;
- monitoring and possibly enhancing ATM reforms; and
- a community awareness and education program designed to make consumers better informed.

International regulatory changes

Finally, I should say a few words about international regulatory reforms. The implementation of these reforms presents a significant challenge for the domestic banking industry and our regulators.

Clearly, the GFC demonstrated severe weaknesses in financial regulation in some markets. It exposed insufficient capital, too little attention to liquidity, incompetence in ratings agencies, and incentives for the executives of some institutions that encouraged inappropriate risk-taking. It also highlighted weaknesses in accounting standards.

As a response to these issues, the G20 countries (of which Australia is a member) have agreed to implement reforms of the regulatory architecture applying to banks. These reforms are intended to strengthen the global financial system; to reduce the likelihood; and severity of future financial crises.

The key reform areas on the G20 agenda are: strengthening the global standards for bank capital and liquidity; addressing the special risks posed by large systemically important financial institutions; and reforming banks remuneration practices. These reforms will be implemented over the next decade.

The Australian Government, assisted by the RBA, APRA and the Treasury has actively participated in developing this reform agenda.

Implementation of these global reforms will enhance the stability of the Australian banking system and reinforce Australia's already robust financial regulatory environment.

In an environment where the Australian banking sector remains heavily reliant on funding from offshore markets, the benefits of implementing the G20 reforms are very likely to outweigh any of their costs.

That said, implementing the reforms will need to be tailored appropriately to take account of Australia's circumstances, while remaining consistent with internationally agreed reforms. It is important that we get the balance right between enhanced financial system stability and the rising costs associated with greater regulation.

Conclusion

Australia's banking industry has emerged from the GFC in a comparatively strong position. Its reputation globally has been enhanced.

But the industry and policy makers face significant challenges relating to the cost and stability of funding, increasing competitive pressures to enhance consumer welfare and implementing international regulatory reforms.

Enhancing competitive pressures in the industry is particularly important. Competition is the cornerstone of efficiency and consumer welfare gains in any market.

But competition needs to be balanced with maintaining stability. A safe and stable banking system is a critical component of the nation's economic infrastructure.

The Government and policy makers look forward to working with the industry to meet the challenges I have raised today, as well as implementing the Government's reform package announced on the weekend.

Thank you.

Economic and financial trends and globalisation over the next 15 years

Dr David Gruen¹
Executive Director (Domestic), Macroeconomic Group

Address to the Scenario Development Forum for Skills Australia and the Academy of the Social Sciences in Australia, 7 February 2011

¹ The views in this article are those of the author and not necessarily those of the Australian Treasury.

Introduction

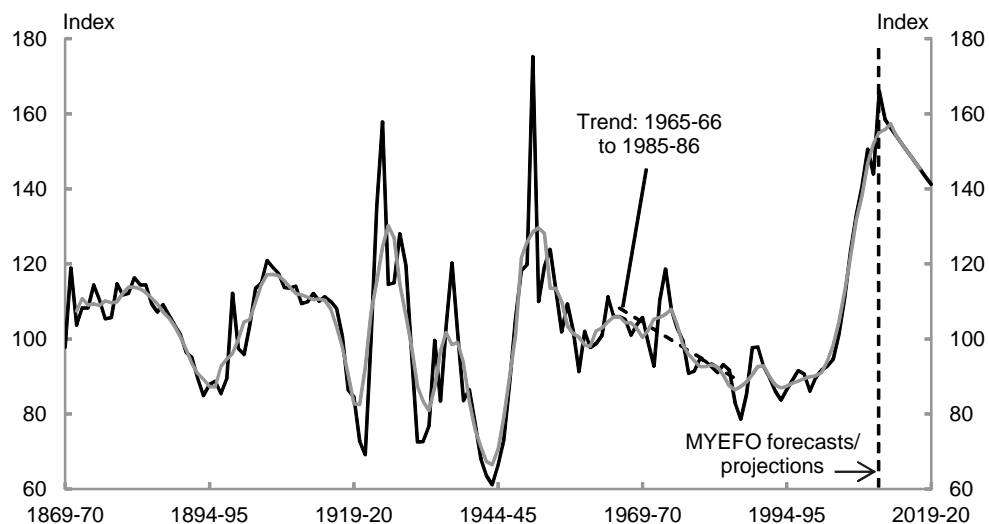
The re-emergence of China and India into the global economy is the most important global economic development likely to have an impact on the industrial structure, and hence the demand for skills, in the Australian economy over the next 15 years or so. Together accounting for slightly more than one-third of the people on the planet, China and India are growing rapidly and should continue to do so, which will continue to raise demand for mineral and energy commodities of which Australia has abundant supply.

The implications for Australia over the coming 15 years will depend on how rapidly the global supply of commodities rises to meet rising global demand, and on whether any economic or political events conspire to interrupt (or derail?) the rapid economic growth that China and India have enjoyed for the past couple of decades.

Re-emergence of China and India

The most striking manifestation of China's and India's rapid growth on the Australian economy is the behaviour of the terms of trade over the past several years. Australia is currently experiencing the largest sustained boost to the terms of trade in our history (at least it is if forecasts for the terms of trade over the next couple of years are roughly correct). As far as the data allow us to make such comparisons, the current five-year centred moving average of the terms of trade is much higher than it has been at any time in the past 140 years (Chart 1).

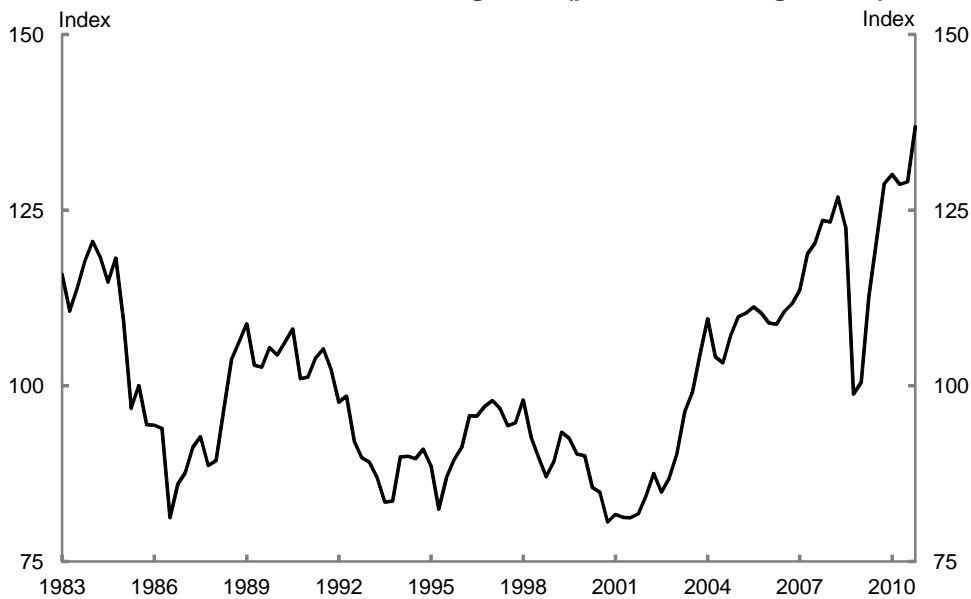
Chart 1: Terms of trade (index 1900-01 to 1999-00 = 100) and 5-year centred moving average



Source: ABS cat. no. 5206.0, Reserve Bank of Australia and Treasury.

This high level of the terms of trade is having a profound impact on the Australian real exchange rate, which is at its highest level, and currently about 35 per cent above its average over the 27 years since the Australian dollar was floated in December 1983 (Chart 2). This in turn is having a profound impact on the structure of the traded sector of the Australian economy. In particular, those parts of the traded sector not linked in some way to the boom in the production of mining and energy commodities are facing severe and sustained competitive pressure from foreign competitors.

Chart 2: Australian real exchange rate (post-float average = 100)

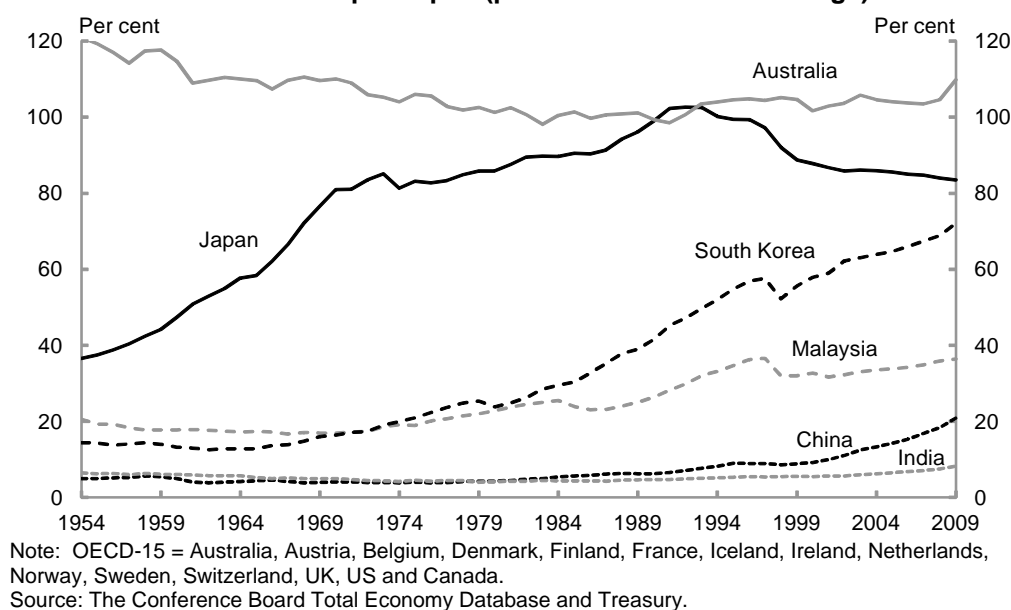


Source: Reserve Bank of Australia and Treasury.

An issue of central relevance to this forum is the likelihood that high levels of the terms of trade, and hence the real exchange rate, will be sustained for much of the next 15 years.

On this point, it is worth noting that the high terms of trade is being driven predominantly by rapid economic growth in Asia, and particularly in the Asian giants, China and India. Even though China and India have been growing rapidly for the past few decades, they remain at the early stages of their economic development. Their standards of living relative to that of the developed world (as proxied by the ratio of their GDP per capita at PPP exchange rates to that of the 15 OECD countries with the highest standards of living) are currently lower than was Japan's standard of living in the early 1950s relative to the developed world's standard of living at that time (Chart 3).

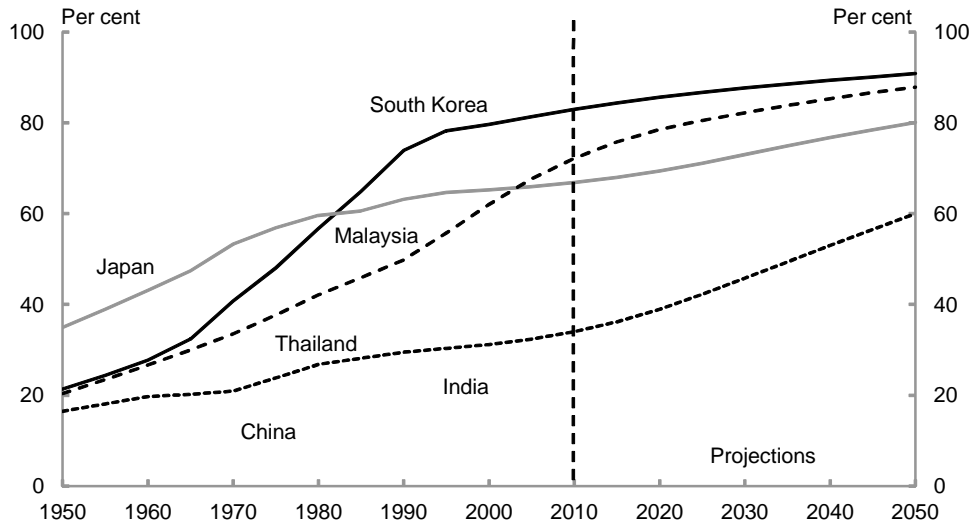
Chart 3: GDP per capita (per cent of OECD-15 average)



From this level of development relative to the developed world, Japan – followed by a string of other East Asian economies – experienced strong catch-up growth for a few decades as their standard of living climbed closer to that of the developed world. Based on this experience, China and India should continue strong catch-up growth for at least a few more decades – and certainly for the next 15 years. Of course, nothing is for sure, and a range of accidents could intervene to render this prediction wide of the mark.

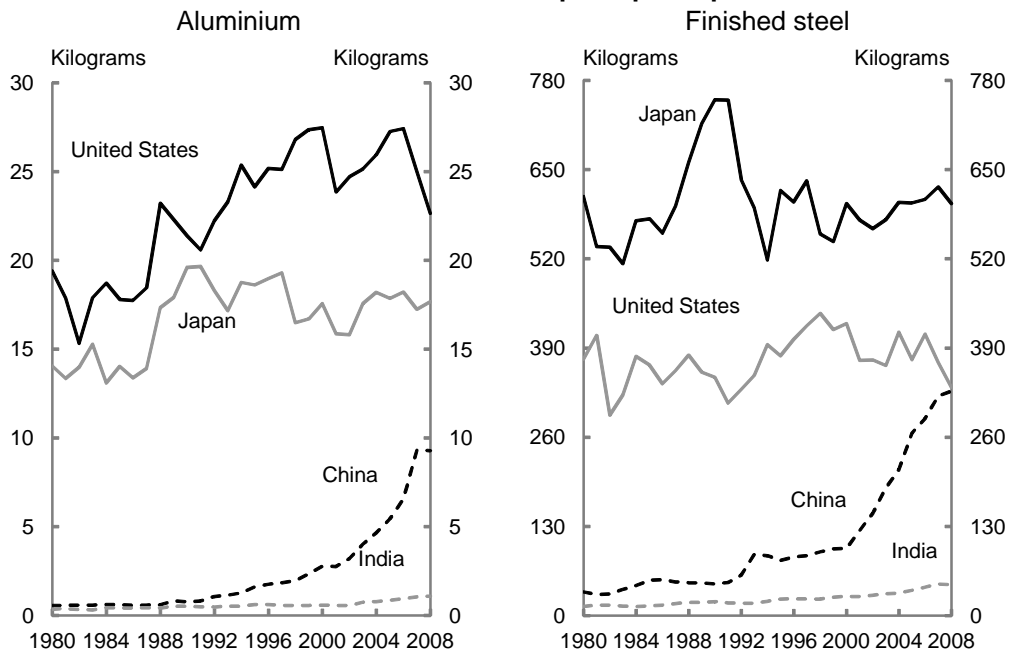
Along with rapid economic development comes rising urban population shares and, at least at these early stages of economic development, rising per capita consumption of a range of mineral and energy commodities (Charts 4 and 5).

Chart 4: Urban population shares



Source: United Nations population database.

Chart 5: Mineral consumption per capita



Source: ABARE, Steel Statistics Yearbooks and Treasury.

It therefore seems most likely that there will be strong growth in demand for the mineral and energy commodities (particularly iron ore and coal) that Australia produces for at least the next 15 years.

Economic and financial trends and globalisation over the next 15 years

By itself, strong growth in demand does not guarantee that commodity prices (and therefore Australia's terms of trade) will remain high. The extremely high rates of profitability associated with the production of these commodities are bringing forth very significant global supply responses.

There are a range of possible scenarios here. One possibility, which presumes no serious prolonged adverse developments that derail the catch-up process in China and India, is that average prices for commodities remain relatively high – well above the average cost of production – for an extended period to maintain strong financial incentives for continued rapid exploration and development of new mining capacity (Garnaut 2006).

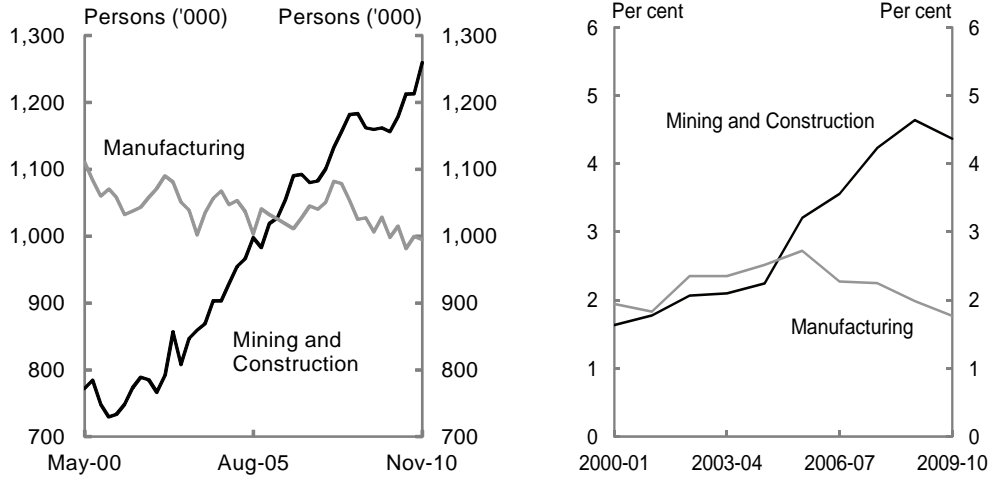
An alternative possible scenario is that, in the rush to exploit the current extremely high rates of profitability, so much global supply is brought on stream that commodity prices fall substantially over the next several years – back closer to the marginal cost of production, or even below it for some time.

While these scenarios are both possible, it seems most likely that the terms of trade will be significantly higher on average over the next couple of decades than they were in the couple of decades preceding the current mining boom.

High resource prices, combined with a high Australian real exchange rate, are currently driving factors of production – both labour and capital – out of non-resource parts of the traded sector (including many, but not all, parts of manufacturing) and into mining and construction (Chart 6).²

2 Much of the increase in construction activity and employment are associated with the mining sector, but some is also associated with higher infrastructure spending by State and Federal Governments.

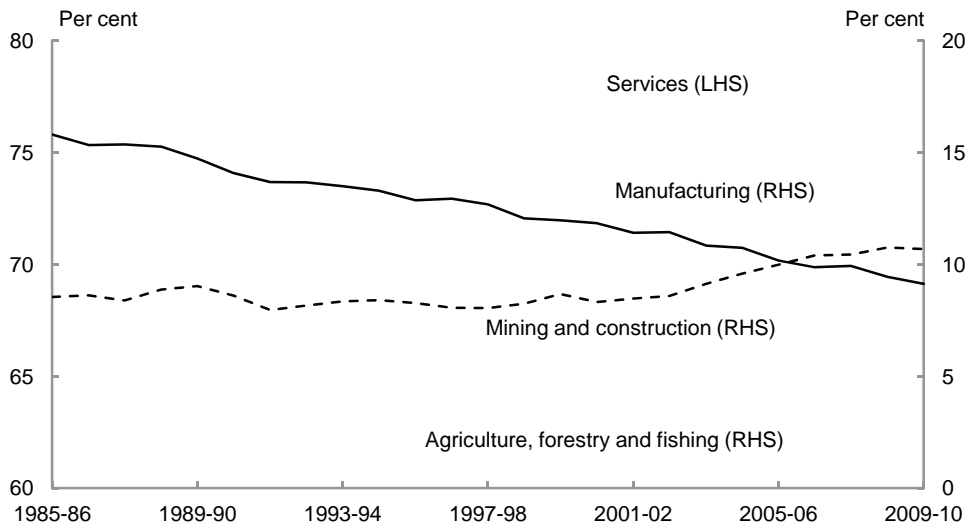
Chart 6: Australian employment and investment by industry



Source: ABS cat. no. 5206.0, 6204.0, 6291.0.55.003 and Treasury.

The strongly rising share of employment in the mining and construction sectors is a relatively recent phenomenon, dating from the beginning of the mining boom, around 2003-04. But the associated decline in the share of employment in manufacturing is the continuation of a trend that has been evident for several decades (Chart 7).

Chart 7: Three speed economy — employment share by industry



Source: ABS cat. no. 6291.0.55.003 and Treasury.

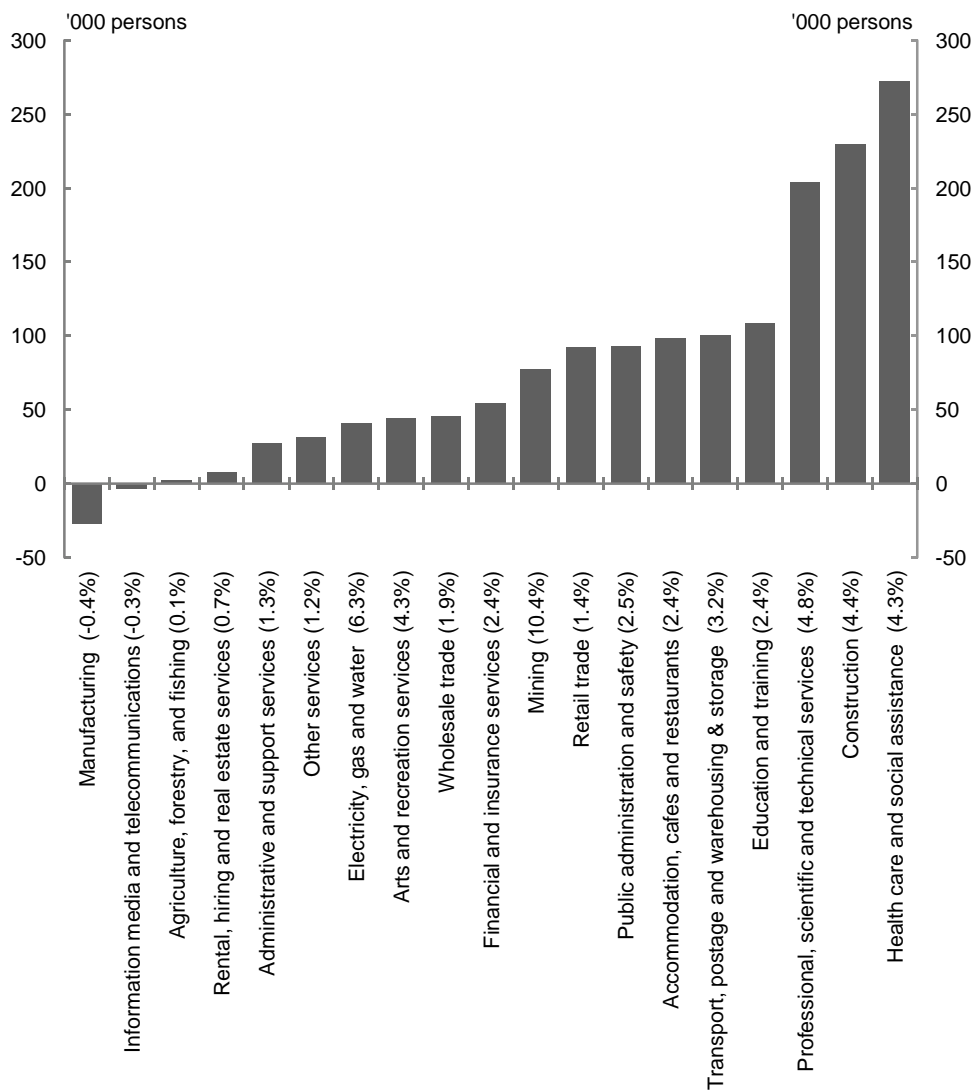
Moreover, for an extended period, the services sectors have accounted for a rising share of employment, and this trend has been affected hardly at all by the mining

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boom, with the services sectors now accounting for over three-quarters of the employment in the economy.

It is also important to keep in perspective the relative sizes of the sectors of the economy. Although there has been strong employment growth in mining and construction, service sectors (particularly health care and social assistance; professional, scientific and technical services; and education and training) have together accounted for far more of the economy's employment growth since the beginning of the mining boom than have mining and construction (Chart 8).

Chart 8: Employment change by industry, 2003-04 to 2009-10



Note: Average annual growth in parentheses.
Source: ABS cat. no. 6291.0.55.003 and Treasury.

Even if the terms of trade remain high (which, in turn, may lead to continued strong growth in the mining and construction sectors – though this is clearly not assured), it seems most likely that growth in the number of people employed in the services sectors will continue to outstrip growth in the number employed in mining and construction.

A related development, and one that is likely to be relevant over the next 15 years, is increased direct competition in the non-resource parts of the Australian traded sector from China and India, with flow-on effects to employment in those sectors of the Australian economy. The most obvious parts of the Australian traded sector likely to be subject to this increased direct competition are manufacturing – especially as Chinese and Indian production moves to increasingly sophisticated manufacturing goods (for example, automobiles) as their real wages rise, but also parts of the IT sector, where lower costs, especially in India, provide a continuing incentive to outsource. The high level of the Australian dollar acts to accelerate these trends.

Productivity

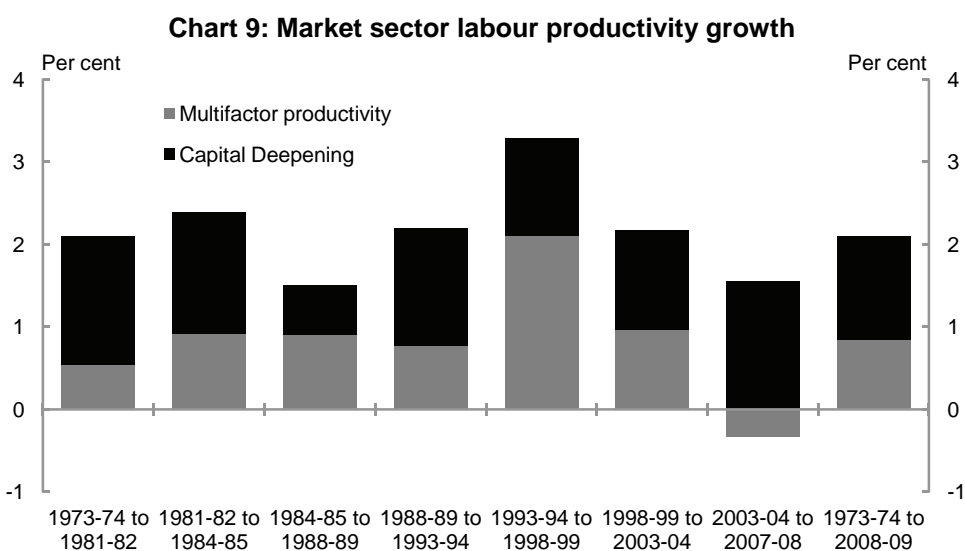
In thinking about future prospects, it is as well to keep in mind that productivity growth is particularly hard to forecast. To give two prominent examples, neither the global slowdown in productivity growth in the mid 1970s nor the acceleration in the US in the mid 1990s was predicted.

Given this difficulty, in successive Intergenerational Reports, labour productivity is simply assumed to continue to grow at the same rate that it did over the previous thirty years. The 2002 Intergenerational Report assumed future annual labour productivity growth of $1\frac{3}{4}$ per cent, the 30-year average at the time, but by the 2010 Intergenerational Report, the 30-year average, and hence the assumed future growth rate, had fallen to 1.6 per cent.

Notwithstanding the difficulties, it is still of interest to discuss the factors that will be relevant for labour productivity growth over the next 15 years.

The first of these is the prospects for multifactor productivity growth, which has been very weak over the past several years. Measured multifactor productivity growth in the market sector has been slightly negative over the most recent productivity growth cycle, 2003-04 to 2007-08 (Chart 9). This outcome has been attributed by many to a dearth of major productivity-enhancing reforms over the past decade or so (see, for example, Banks 2010). If this suggestion is correct, it would not augur well for multifactor productivity growth over the next 15 years since there are usually significant lags from significant reform to the ensuing productivity benefits. Even

reforms recently underway will take time to have a favourable impact on multifactor productivity growth.



Source: ABS cat. no. 5206.0 and Treasury.

At the same time as multifactor productivity growth has been weak, extremely strong rates of physical investment have seen the capital-to-labour ratio rise much faster than its earlier trend (Lowe 2010). Using a simple aggregate production function, the 2 percentage point increase in the annual growth rate of the capital stock (excluding dwellings) that we have seen over the past five years or so should lift the annual growth rate of labour productivity by something like two-thirds of one per cent (although the duration of this lift in productivity growth depends on the duration of the lift in the growth rate of the capital-to-labour ratio).

Some other plausible developments in the economy should be expected to have smaller effects on productivity growth – some favourable, others adverse.

Well-designed economy-wide market-based mechanisms for reducing Australia's greenhouse gas emissions are projected to reduce annual labour productivity growth by around 0.1 per cent, even for quite deep cuts in emissions (Australian Government 2008). Of course, were alternative regulatory, or other non-market-based, mechanisms for reducing greenhouse gas emissions implemented, that would be expected to have much more adverse effects on the economy's aggregate labour productivity growth.

Plausible shifts in the industrial structure of the economy driven by the high terms of trade should be expected to have only small effects on the economy's aggregate annual rate of productivity growth. A continued rise in mining's share of aggregate output

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should raise aggregate labour productivity, but most of this effect is already captured by the higher capital-to-labour ratio in mining.

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Some problems in legislating for economic concepts — a judicial perspective

Justice Tony Pagone¹

This paper was delivered at Treasury on 2 December 2010 as part of the Revenue Group seminar series.

¹ The Hon Justice Tony Pagone is the judge in charge of the Commercial Court, Supreme Court of Victoria. Prior to his appointment he was a Queen's Counsel practising barrister specialising in taxation law at the Victorian Bar. He has practised widely in commercial, constitutional, public and human rights law and has held the position of Special Counsel at the Australian Tax Office. He has also been a member of the Victorian Bar Council, the Taxation Institute of Australia and the Law Council BLS Executive of which he was chairman in 1999 and 2001. Justice Pagone was appointed a Professorial Fellow at the University of Melbourne in 2002 and teaches in the postgraduate program at both the University of Melbourne and Monash University. He has been an associate and general editor for the Australian Taxation Review and is an area correspondent for the International Human Rights Reports. He is a recipient of the Monash University Distinguished Alumni Award, and has recently published a book entitled *Tax Avoidance in Australia* (The Federation Press, 2010). The views in this article are those of the author and not necessarily those of the Australian Treasury.

When I agreed on the topic for today's meeting I did not realise that the Assistant Treasurer was to issue a discussion paper on 'improving the operation of the anti-avoidance provisions in the income tax law'. That occurred on 18 November 2010 by which stage I was committed to talking on quite a different topic. Had I known of the discussion paper I would have taken that as my topic as I have written and spoken on it many times over several years.

Perhaps, however, I may be permitted to use the topic of anti-avoidance to introduce the problems which I see inherent in the topic selected for today's discussion. The general anti-avoidance provision in Part IVA emerged from what was perceived to be the inadequacies identified by the judiciary with the operation of s260. Many believe that the inadequacies lay less in the terms of s260 than in the judicial interpretation which had been given to it. However, fundamental to the weakness of s260 was the judicial interpretation it was given through what became known as the choice principle.² At the heart of the choice principle was a judicial concern that the words of s260 as they appeared in black ink on a piece of paper permitted of applications which at one extreme could never have been intended by the legislature and which at other points in the continuum between extremities, but well short of the other extreme, was inconsistent with policy objectives which gave tax advantages intended to be taken up by taxpayers. It was lawyers, that is judges, who looked at bare words on a piece of paper and said on occasion that surely the breadth of s260 was not intended to capture everything which its literal meaning might permit.³ It was the same lawyers who said that surely s260 was not intended to apply to choices which the taxing provisions elsewhere encouraged taxpayers to obtain.

These concerns eventually (at least until the post Part IVA decision on s260 in *Gulland*⁴) led to a narrowing of the operation of s260 and the elaboration of a substantial limitation where a choice could be said to have been given by the tax law. It was the ever expanding content of the choice principle that ultimately led to the demise of s260 and the perception that new provisions needed to be enacted. A similar problem is emerging now with the interpretation of Part IVA. In *Hart's*⁵ case two judges adopting the submissions by the Commissioner referred to the task required in s177D as involving a comparison between what was done and an alternative postulate.⁶ Unfortunately the language used by their Honours suggested that this was required as part of identifying the obtaining of a tax benefit in connection with a scheme in s177C. That, it seems, gave birth to the idea that s177C provided a definition of 'tax benefit'

2 *WP Keighery Pty Ltd v Federal Commissioner of Taxation* (1957) 100 CLR 66; *Mullens v Federal Commissioner of Taxation* (1976) 135 CLR 290; *Slutzkin v Federal Commissioner of Taxation* (1977) 140 CLR 314; *Cridland v Federal Commissioner of Taxation* (1977) 140 CLR 330.

3 *Deputy Federal Commissioner of Taxation v Purcell* (1921) 29 CLR 464, 466 (Knox CJ).

4 *Federal Commissioner of Taxation v Gulland, Watson and Pincus* (1985) 160 CLR 55.

5 *Federal Commissioner of Taxation v Hart* (2004) 217 CLR 216.

6 *ibid* 243 [66] (Gummow and Hayne JJ).

which required a comparison between what was actually done (the scheme) with an alternative hypothesis of what the taxpayer would otherwise actually have done if the taxpayer had not done the scheme. This has led to a series of mental gymnastics in a recent line of cases that may, in turn, either seriously undermine the operation of Part IVA or, if the emerging jurisprudence is correct, be exposing what may always have been a fundamental flaw in its drafting.⁷ In this emerging jurisprudence the judges are seeking to give linguistic meaning to words on paper. There is no inquiry into what fiscal or economic purpose is served by construing s177C as requiring a comparison of what was actually done with what the taxpayer would, or might reasonably, otherwise have done. Indeed, it may be hard to see a fiscal or economic point to such a requirement. But the words are there and the generalist lawyer's approach is to supply general linguistic meaning to them.

I begin with these observations to make what I think is a fundamental point applicable to any consideration about the problem of drafting legislation to give effect to economic concepts. That fundamental problem is that those who interpret the law, and those who effect its judicial application, are not economists or fiscalists. They are essentially lawyers who come from diverse backgrounds and interpret the words by reference to non-economic or fiscal content. Indeed, there is a general approach to legislation that its terms should be understood by an ordinary reader and not one versed in a special field of knowledge or discipline: the words used should carry their ordinary meaning unless there is a clear intention shown otherwise. There is sometimes a fundamental mismatch between the underlying economic objectives expressed in statutes and the potentially distorting tools used by lawyers to determine the meaning of words as used and to be applied. This mismatch can be seen in many aspects of judicial application of tax laws. It is not just a question about the ambiguity of words. It is a much more fundamental issue concerning a mismatch between disciplines which sees lawyers apply analytical reasoning which is different from the analytical reasoning of accountants, economists, auditors or people of business and commerce. Embedded in that mismatch of disciplines is a jurisprudential question about whether judges should, or even can, apply the disciplines and rigours of fields of learning in which they have no training or experience.

The judge interpreting tax law finds refuge not in the underlying discipline which the legislation may seek to express but in the words themselves. Sometimes those words are simply inadequate to convey sufficient meaning for a confident decision to be made about how they are to be applied in any given case. That is because the words themselves may be ambiguous and because they are intended to apply in a greater context than initially thought or expressly contemplated.

⁷ See, for example, *Federal Commissioner of Taxation v Lenzo* (2008) 167 FCR 255, 276 (Sackville J); *AXA Asia Pacific Holdings Ltd v Federal Commissioner of Taxation* 2009 ATC 20-151 [118] (Jessup J); *Commissioner of Taxation v AXA Asian Pacific Holdings Ltd* [2010] FCAFC 134.

Uncertainty is an inevitable feature of language.⁸ Words are frequently capable of many meanings, some of which were not, or at least may not have been, intended when used in a particular context. One such example may be seen in *Bourne (Inspector of Taxes) v Norwich Crematorium Ltd*⁹ in the context of a United Kingdom statute where the tax fell by reference to whether a building or structure was for the 'manufacture of goods or materials or for the subjection of goods or materials to any process.'¹⁰ A narrow question raised in that case was whether goods and materials subject to a process included the cremated remains of human bodies. Justice Stamp said of this:

In my judgment it would be a distortion of the English language to describe the living or the dead as goods or materials. The argument of course goes on inevitably to this; that just as 'goods and materials' [sic] is wide enough to embrace, and does embrace, all things animate and inanimate, and so includes the dead human body, so that other words to which a meaning must be given, namely 'subjection' and 'process', are words of the widest import. Parliament cannot, so the argument as I understood it runs, have intended to exclude from the definition a process whereby refuse or waste material is destroyed or consumed by fire and, putting it crudely, for it can only be put crudely, the consumption by fire of the human body is a process. I protest against subjecting the English language, and more particularly a simply English phrase, to this kind of process of philology and semasiology. English words derive colour from those which surround them. *Sentences are not mere collections of words to be taken out of the sentence, defined separately by reference to the dictionary or decided cases, and then put back again into the sentence with the meaning which you have assigned to them as separate words, so as to give the sentence or phrase a meaning which as a sentence or phrase it cannot bear without distortion of the English language.* That one must construe a word or phrase in a section of an Act of Parliament with all the assistance one can from decided cases and, if you will, from the dictionary, is not in doubt; but having obtained all that assistance, one must not at the end of the day distort that which has to be construed and give it a meaning which in its context one does not think it can possibly bear. What has to be decided here is whether what is done by the taxpayer, viz., the consumption or destruction by fire of the dead body of the human being, is within the phrase 'the subjection of goods or materials to any process'. I can only say that, having given the matter the best attention that I can, I conclude that the consumption by fire of the mortal remains of homo sapiens is not the subjection of goods or materials to a

8 Barthes, R, *Criticism and Truth* (Continuum, 2007) 25-28; Umberto Eco, *The Limits of Interpretation* (1990).

9 [1967] 2 All ER 576.

10 *Income Tax Act 1952*, 15 & 16 Geo 6 & 1 Eliz 2, c10, s271(1)(c).

process within the definition of ‘industrial building or structure’ contained in s. 271(1)(c) of the *Income Tax Act, 1952*.¹¹

To the inherent ambiguity in language one may also add determined obfuscation,¹² nurtured, perhaps by self interest or institutional objective.

Ambiguity (or at least uncertainty) may also exist in the concepts expressed in the language quite apart from the ambiguity that may be found in words. Here I have in mind the notorious difficulty of determining whether economically an amount or a part of an amount is properly to be regarded as on capital or revenue account. In *Lomax (HM Inspector of Taxes) v Peter Dixon and Son Ltd*¹³ Lord Greene MR observed:

In many cases, however, mere interpretation of the contract leads nowhere. If A. lends B. 100*l* on the terms that B will pay him 110*l* at the expiration of two years, interpretation of the contract tells us that B.’s obligation is to make this payment. It tells us nothing more.¹⁴

The 10*l* difference in the payment could be accretion to capital or it could be in the nature of interest return upon the capital. It is a simple example which may be added to. The litigation about whether discounts on bills of exchange or promissory notes considered in *Coles Myer*¹⁵ is another example. Many income producing assets (rental properties, shares, etc) carry with them returns that may economically be seen by some as referable to capital or as income. Even the nominal value of money by remaining unchanged over time may be seen either as a diminution in capital or a negative outflow of income.¹⁶ The point is that even within the disciplines of economics or accounting there may be differences about the ‘economic’ or ‘accounting’ nature of something.

The lawyer’s training and tools do not equip a judge to apply economic, accounting or business concepts with sufficient reliability. An example of the difference in approach between lawyers on the one hand, and accountants, economists, people of business, on the other hand, may be seen in the decision in *Federal Commissioner of Taxation v McNeil*¹⁷ concerning the taxability as ‘income’ of a receipt by a shareholder of \$514 from the sale on her behalf of rights to sell shares in St George Bank Limited. Mrs McNeil had previously held 5,450 shares in the bank from which, over the years,

11 *Bourne (Inspector of Taxes) v Norwich Crematorium Ltd* [1967] 2 All ER 576, 578 (Emphasis added).

12 *Pyneboard Pty Ltd v Trade Practices Commission* (1982) 57 FLR 368, 375 (Northrop, Deane and Fisher JJ).

13 [1943] 1 KB 671, 675.

14 *ibid*.

15 *Coles Myer Finance Ltd v Federal Commissioner of Taxation* (1993) 176 CLR 640.

16 *Burrill v Federal Commissioner of Taxation* (1996) 33 ATR 133.

17 (2007) 229 CLR 656.

she derived dividends upon which she paid tax in the ordinary way.¹⁸ In January 2001 the bank announced its intention to buy back about 5 per cent of its issued share capital at a fixed price of \$16.50 per share. Mrs McNeil thus came to have 272 rights to require the bank to buy her shares.¹⁹ These rights were separately listed for trading on the Stock Exchange which, at the time in question, had a value of \$1.89 per share.²⁰ Mrs McNeil took no steps to exercise her rights, with the consequence, under the transaction documents, that the shares were transferred to a merchant bank which sold them to the Bank for \$2.12 each for a total of \$576.64.²¹ Part of that receipt was treated as a taxable capital gain, but the bulk, \$514, was treated by the Commissioner as ordinary income under general principles.²²

The occasion by which Mrs McNeil came to have the rights was, from the company's point of view, a partial return of capital to its shareholders. Mrs McNeil, as a shareholder, and from an accounting and economic point of view, was receiving part of the capital value of her shareholding upon the sale of the sell-back rights. The High Court, by a 4-1 majority, held otherwise, focussing upon Mrs McNeil's individual receipt of the money and upon a finding that her shareholding, in legal terms, remained unchanged as a matter of legal analysis. The law treated the receipt as income although in economic terms and commercial reality her capital wealth as a shareholder in the Bank before and after the transaction had not changed (except, of course, that it was reduced by reason of the tax she had to pay).

The majority judgment in *McNeil* began its consideration of the issues by recalling that the character of the sell-back rights had to be determined from the point of view of the taxpayer (the recipient) and not from the point of view of the bank (the payer).²³ Their Honours next reasoned that 'a gain derived from property has the character of income', including a gain to an owner who receives the gain passively.²⁴ An important inquiry relevant to the ultimate issue was, therefore, whether the gain was derived from property which the taxpayer continued to hold in contrast to a receipt in exchange for a disposal of part of the capital. This led their Honours to consider whether the rights enjoyed by Mrs McNeil arose from and were 'severed from, and were a product of, her shareholding in [the bank] which she retained': in short, was the capital severed or did it remain intact; was the receipt in exchange for what was severed or did it proceed from capital which remained whole?²⁵ Critical to their Honours' conclusion that the receipt was a product of (and not in exchange for a part

18 *ibid* 660 (Gummow ACJ, Hayne, Heydon and Crennan JJ).

19 *ibid*.

20 *ibid* 661.

21 *ibid* 661-2.

22 *ibid* 662.

23 *ibid* 663.

24 *ibid*.

25 *ibid* [21].

of) the capital, was their Honours' analysis that Mrs McNeil's shareholding in the bank, as a matter of legal analysis, 'remained untouched'.²⁶

The most significant point in the conclusion of the joint judgment was that Mrs McNeil's shareholding in the bank 'remained untouched'²⁷ as a matter of legal analysis of the shares. An accountant or an economist may have analysed the transaction quite differently and may have seen the transaction from Mrs McNeil's point of view as an affair wholly on capital account (as did Callinan J).²⁸ On such an analysis, Mrs McNeil, as a shareholder, had a number of shares, and came to receive part of their actual economic and commercial value in cash in consequence of her capacity as a shareholder. The number of shares she held before and after her receipt of cash remained the same, but part of the economic value of her investment in those shares was returned to her (and did so in her capacity as a shareholder) without her doing anything and for no other reason than because she was a shareholder. From her point of view, the accounting and economic consequence of the receipt upon the sale of the rights was that her shareholding was in economic terms, and in accounting terms, reduced in value by the amount she received in cash and, on that analysis, a portion of *the value* of her shareholding was 'severed' from the worth of the whole of her shareholding and paid to her in cash. That appears to have been the view adopted by Callinan J when his Honour concluded that if one were 'to look only to what [Mrs McNeil] had in her hands', she received money 'which effectively gave shareholders access to a component of [capital] that they would not otherwise have had'.²⁹

Similar differences between the lawyer's tools and the understanding of economists and accountants may be seen on the deduction side of the distinction between capital and income. Capital losses and outgoings are not usually deductible against income receipts and the character of a loss or outgoing as either being on revenue account or on capital account can have profound consequences for fiscal outcomes. The legislative amendments and line of litigation involving convertible notes and instruments with a component of deductible outgoings illustrate this.³⁰

26 *ibid* [22].

27 *ibid*.

28 *ibid* 672 [55] (Callinan J reached the contrary conclusion from the majority of the Court placing significance on the impact upon Mrs McNeil as a shareholder when considering, as his Honour said, the 'transaction as a whole').

29 *ibid* [56]. See also Bloom, D Q.C., 'Taxpayer's Heaven: The Citylink Decision - The Opposite of Heaven: The Decision in *McNeil*', (Paper presented at the Taxation Institute of Australia, 52nd National Convention, Hobart, 16 March 2007); Justice Richard Edmonds, 'Recent Tax Litigation: A View from the Bench' (2008) 37 *Australian Tax Review* 79.

30 See, for example, *Macquarie Finance Ltd v Federal Commissioner of Taxation* (2004) 210 ALR 508 (Federal Court); *Macquarie Finance Ltd v Federal Commissioner of Taxation* (2005) 146 FCR 77 (Full Court).

The cases involving finance companies raising tier one capital through instruments with an obligation to pay an interest component also illustrate the tensions between the lawyer's analysis of tax law and the economic view of transactions. The raising of capital, whether by a financier or by any other taxpayer, carries with it a cost: investors buying shares expect a return on their investment and lenders who have lent money similarly require an economic return on the funds advanced. There is a cost whichever way funds are raised from the point of view of the taxpayer raising funds but the cost will differ by the impact of tax depending upon whether the funds are obtained as loans (because interest payments are deductible to the payer) or as contributions to equity (because dividends are not deductible to the payer). Similarly, from the point of view of the provider of funds (whether as investor or as lender) there will be an expectation of preserving capital as well as an economic return upon the capital, but there will be a difference in expected risk and return depending upon whether the funds are provided as investor or as lender. The parties agree in their deals to share or minimise risks and returns through the type, form and detail of the transactions they enter into and predictability of fiscal outcome is a crucial element of their negotiation and deal. Transactions differ in the type and extent of the risk exposure taken by the provider of the funds and the degree to which a company is willing to share the rewards of its risks and endeavours with those who have provided the funds that make that possible. How much risk each will take and how much of the reward each may enjoy are part of the economics of the bargain finally made. Embedded in those dealings, and which govern the shape and content of the transactions and the outcomes agreed to, is the fiscal treatment of the different forms in which transactions may take shape.

The purposive construction of all legislation requires judges to give effect to the underlying objectives which legislation seeks to achieve. Legislation drafted to give effect to economic concepts is no exception. The problem is not a lack of legislative direction but that judges do not have the training, background or resources to implement legislation as an economist, accountant or person of commerce would require. There is also a fundamental concern about how judges should act upon economic concepts. Such concepts are traditionally treated as matters of evidence to be given by experts whose evidence is subject to testing through cross-examination. The idea that a judge should apply some personally held view of economics, accounting or commerce may be inconsistent with the judge's role as independent (non-partisan) interpreter of legal text enacted by parliament in ordinary language.

Drafting legislation by reference to economic principles is unlikely in the long term to achieve the objective of ensuring that legislation is interpreted and applied by reference to economic principles. A better long term solution may be in a structural reform that places economic content into the act of decision making. Legislation seeking to implement economic concepts is an attempt to achieve that but it may fall

short if the people interpreting the words and applying them judicially lack the training or resources to give effect to the economic concepts. Two other models, however, come to mind as structural means by which economic outcomes might be integrated into and be made part of the fabric of decision making.

One model is the establishment of a specialist court with appointees who have the requisite training and experience to understand the economic concepts sought to be achieved and the training to give effect to them. Specialist courts are not popular and much can be said against their adoption.³¹ It is of fundamental importance that the courts declaring the law do so uniformly across all law. It is also desirable that there be a healthy input of non-specialist decision making in that task to ensure that the law does not become distorted through the institutionalisation of views and application of only specialist perception and lore. Many of these concerns can, however, be adequately met by ensuring that any appeal from a specialist court be to a general appellate court whose judges are drawn from a broad pool.

An alternative model, or perhaps merely a variation of the first model, might be to adopt for tax something like that adopted for Trade Practices. If economic concepts are central to the proper interpretation and development of tax laws, it may be better to establish something akin to the Trade Practices Tribunal composed of a judge, an economist and perhaps someone from business or the tax office so that the decision of the tribunal will necessarily be informed by the internal deliberations of those with the required knowledge and training. The parties to any dispute would still be able to test and argue about any economic content and would have rights of appeal on strictly questions of law, but such a specialist tribunal would ensure that the decision maker (being a composite of lawyers and others) would in part reflect other disciplines, expertise or experience.

The lesson of history is that much depends upon the identity of those given the task of interpretation, decision making and application. We have grown up with a model that assumes that words can adequately reflect the intention of an author without taking account of what the reader brings to the text when reading it and applying it. The problem is not that the writer does not know what he or she may have intended but that the reader will see the words with the reader's mind. Drafting legislation to set out the author's intention can only go so far. What ultimately is necessary is to secure the reader's adoption of what the author sought to achieve. The implementation of tax legislation by reference to economic concepts (or accounting or commercial concepts for that matter) are best secured by ensuring that the person implementing them (at

31 Kirby, M (former Justice of the High Court of Australia), 'Hubris Contained: Why a Separate Tax Court Should be Rejected', (2007) High Court of Australia <http://www.hcourt.gov.au/assets/publications/speeches/former-justices/kirbyj/kirbyj_3aug07.pdf> at 13 December 2010.

Some problems in legislating for economic concepts — a judicial perspective

least at first instance) has the requisite training and experience. The creation of a specialist tribunal with economists (for example) as members is a more likely way of securing the objective than the processes adopted to date.

Key themes from Treasury's Business Liaison program

Overview

As part of its quarterly Business Liaison Program, Treasury met with 51 businesses and organisations in eight capital cities and regional centres in February, and held teleconferences with a further three businesses in early March. Treasury greatly appreciates the commitment of time and effort made by the businesses and industry associations that participate in this program.¹

Overall, liaison contacts pointed to continued strength in the economy underpinned by the mining sector, with strong external demand for resources exports and a range of major mining investment projects underway and in the pipeline. Elsewhere the economy is patchy, with weakness in manufacturing, retail trade and residential construction. The floods and cyclone in January and February have had a substantial impact on rural and non-rural production and have caused significant damage to infrastructure.

Activity

A focus of the round was the economic impact of the floods and Cyclone Yasi in January and February 2011. Several states were affected, but Queensland bore the brunt of the economic impact.

The key economic impact has been through the effects on coal production and exports. The floods halted production in mines and cut key transport infrastructure. Contacts suggested that the loss of coal production is estimated to be between 20 million and 30 million tonnes. Although weather conditions have normalised, mines are still affected by flooding: some mines are still flooded and face logistical and regulatory hurdles (because of the water salinity) in pumping out the water. While the greatest impact will have been in the March quarter, effects appear likely to extend into the June quarter. Lower coal exports have been partly offset through higher prices, which have increased sharply in response to the temporary supply constraints. Notwithstanding the immediate problems, prospects for the industry are strong, with businesses looking to expand production through increased investment.

The floods have led to a significant loss of agricultural production in some states, with both the volume and quality of output suffering. That said, contacts noted that, floods aside, the rains have been good for the sector overall, and are encouraging a positive outlook. Rising prices for crops and livestock are restoring optimism, and are leading some farmers to increase their overall expenditure and rebuild their stocks.

1 A detailed explanation of the Treasury Business Liaison Program is provided in the Treasury *Economic Roundup*, Spring 2001.

The floods and cyclone have also had an adverse effect on the tourism industry, reducing numbers during the crisis but also affecting near-term prospects. Contacts noted that the tourism industry was already labouring under a range of problems: aging infrastructure, a high cost structure, increasing competition from the Asian region and the high dollar, and that slower growth is likely to persist for some time.

Contacts reported that the elevated exchange rate is also placing competitive pressure on other firms in the tradeables sector that are not benefiting from the mining boom. In some cases this is creating an uncertain outlook.

Contacts confirmed that households appear to be more cautious with their money, with retail sales subdued and residential construction weak. Contacts also mentioned that interest rate rises and banks' tighter financing requirements are affecting buyer confidence.

Contacts suggested that there are tentative signs that the commercial property sector is starting to recover, and gaining strength in some parts of Australia, particularly inner-city commercial developments. However, it remains very weak in some areas, particularly in Queensland.

Employment and wages

The expectation is that the labour market will approach capacity in the next two years, with strong employment growth and low unemployment.

There is increased demand for some specialised skills, particularly in Western Australia and Queensland, and this is expected to flow through to other states' labour markets. Skills shortages within the resources sector and in some other sectors, notably construction, may start to drive wage pressures, with some employers saying they are willing to pay a premium to attract skills. This may see pressures emerge in other sectors as labour migrates to higher-paying firms. Other businesses in the sector are already reporting increased competition for labour, and some firms in the weaker sectors are reporting a reduction in staff numbers.

Firms are taking various approaches to bridge the overall skills gap. Some are importing labour, including from overseas branches of multinationals, and also importing plant and equipment to reduce the need for domestic construction. Other firms are shifting to less labour-intensive production.

To date, wage agreements are generally providing increases of around 3 to 5 per cent, with larger rises being experienced in some specialised professions and trades.

Costs and prices

Costs and price pressures remain contained, although contacts are experiencing increased fuel and utility costs, attributing the latter to increased network charges and capital expenditure. Margins were being squeezed for those contacts with limited scope to pass costs through to consumers.

Contacts reported that the higher dollar is reducing the cost of imported inputs, although the reductions are sometimes slow to feed through.

Retail discounting prevailed through Christmas and into the New Year in response to weaker demand. Increased consumer caution and the wet weather are thought to be partly behind the weakness as are interest rates, although the cash rate had remained steady since the last liaison round.

The outlook for commodity prices remains robust, underpinned by expectations of ongoing strong demand from China and India. Recent disruptions to coal supply associated with adverse weather events in Queensland have resulted in a spike in coal prices, which are expected to unwind as supply comes back online. Contacts remain fairly bullish on iron ore prices, noting that ongoing global demand pressures will underpin prices in the medium term. More broadly, contacts anticipate that commodity prices will ease off gradually over the medium term, rather than falling sharply.

Financing and Investment

Credit conditions remain tight for some borrowers, particularly medium-sized businesses, although conditions have improved significantly since the difficult conditions during the global financial crisis.

The robust outlook for mining continues to underpin a pipeline of strong mining investment, which will boost production. Along with infrastructure and port expansions, this will help the sector to meet demand, reducing some of the costly delays at ports and terminals which are currently hampering the industry.

Menzies: treasurer in transition to war

John Hawkins¹

Sir Robert Menzies was Australia's longest-serving prime minister, and for almost a year at the start of World War II was also its treasurer. He was therefore responsible for the transition to a war economy, although he delegated much of the responsibility to assistant minister Percy Spender.



Source: National Library of Australia.

1 The author formerly worked in the Domestic Economy Division, the Australian Treasury. The views in this article are those of the author and not necessarily those of the Australian Treasury.

Introduction

Sir Robert Gordon Menzies, PC CH held the position of treasurer for almost a year during his first term as prime minister in 1939-1940. A number of writers emphasise, however, that the Menzies of the 1930s was a much less developed and adept politician than the master of the 1950s and 1960s.²

Menzies had 'a wide interest in men and affairs'.³ Most, however, believe this did not extend to economics.⁴ 'Nugget' Coombs was asked about Menzies' concern for the economy and replied that 'most of the time he would rather that somebody else worried about it'.⁵ Menzies himself said 'I am no economist'.⁶

Menzies' life before politics

Menzies was born on 20 December 1894 in Jeparit, Victoria. He was fond of saying he 'was not born into the purple'; his parents were storekeepers. His father was later a Victorian MLA. Winning scholarships took the young Menzies to Wesley College and the University of Melbourne, where he graduated in law with impressive results (although only a pass in political economy).⁷

Admitted to the bar in 1918, Menzies specialised in constitutional law and achieved acclaim, becoming the youngest Kings Counsel in Australia.⁸ In 1920 he married Pattie Leckie, whose father was also a politician.

2 For example, Brett (1992, p 4) distinguishes between the 'aloof, ambitious politician of the 1930s, too clever by half ... and the wiser, humbler, more mature Menzies of the second prime ministership'. Miller (1995, p 55) and Reid (1980, p 42) have a similar view. Even Menzies himself conceded 'I had yet to acquire the common touch, to learn that human beings are delightfully illogical ...'; Menzies (1967, p 57).

3 Buchanan (1940, p 1).

4 For example, Melville (1993). Ellis (1961, p 9) and Miller (1995, p 57). A minority take a different view: Hasluck claims 'it was not in spite of, but because of, his Prime Ministership, that stability of the economy was achieved'; Hasluck (1995, p 136).

5 Hazlehurst (1979, p 368).

6 Introduction to undated typescript of short book on current affairs, *Menzies Papers*, National Library of Australia, MS 4936, box 354.

7 Hazlehurst (1979, p 20).

8 Dawes (Chapter 5). In some of his early cases he represented trade unions and there were rumours that some Labor Party figures contemplated asking him to stand as a Labor candidate.

The Victorian parliament

Menzies joined the Nationalist Party and won a by-election for the Victorian Legislative Council in 1928, transferring to the lower house seat of Nanawading in 1929. Menzies was appointed attorney-general and minister for railways as well as deputy premier after the 1932 election.

At this stage, he was a strong supporter of conservative economic policies, emphasising the need for manufacturers to 'reduce costs', a euphemism for 'cut wages'. Indeed Menzies was advocating a more conservative and contractionary policy than was adopted in the Premiers' Plan. He did not believe that Australian bondholders should have to bear any sacrifice. As for reducing interest payments to British holders of Australian bonds, Menzies thought 'it would be better for Australia that every citizen within her boundaries should die of starvation'⁹

Going federal

Menzies transferred to the federal parliament, taking the blue ribbon seat of Kooyong at the 1934 election. Lyons appointed him attorney-general and minister for industry. By December 1935 he was also deputy leader of the United Australia Party (UAP).

Menzies was impatient for the leadership and even contemplated leaving parliament as Lyons stayed in the post.¹⁰ (However, the ardent Anglophile took some solace in his first trip to England in 1935 for George V's jubilee, when the country boy from Jeparit dined at the Palace. He returned to London in 1936 and 1938.)

While Casey was at the Imperial Conference in 1937, Menzies was acting treasurer. He did not entirely enjoy it, remarking 'I think I will be thoroughly relieved when Dick gets back from England. To be a Treasurer immediately before an election is to be the most unpopular man in Cabinet. When I am not being menaced I am being wooed with soft words and bombarded with persuasive letters, most of which come from WM Hughes'.¹¹ There were rumours that Menzies may have been appointed treasurer after the 1937 election but he remained as attorney-general.¹²

9 *The Age*, 4 May 1931.

10 He said he had been offered an attractive posting, but was talked out of resigning by Page, ironically given events soon to occur; Page (1963, p 265).

11 Menzies to Keith Officer, 21 June 1937, cited in Martin (1993, p 213).

12 *Argus*, 27 November 1937.

Treasurer and prime minister

When Lyons died in April 1939, Menzies only narrowly defeated the septuagenarian Hughes for the party leadership. He then had to face an excoriating attack by Page in the House, aimed at preventing him becoming prime minister.

Menzies decided to serve as treasurer himself, appointing Spender as his assistant minister.¹³ His September 1939 budget was delivered within days of the outbreak of World War II. Menzies described it as 'a budget for preparation and not a budget for conflict'.¹⁴ He repeatedly warned in his speech that it was 'prepared in a time of peace, it is being delivered in a time of war ... it must be regarded as having an extremely tentative character'.¹⁵ With wool and wheat prices falling, it was an austere effort, raising income and sales taxes to cover increased spending and falling customs revenues. While noting recent deflationary forces, Menzies uncertainly suggested 'for all I know, in the course of the next few years we may have to encounter inflationary forces'.¹⁶ Soon after the outbreak of war, the Government took steps to introduce price controls in collaboration with the states.

Menzies established an Economic Cabinet, which he chaired, in December 1939 but it appears to have fizzled out around May 1940.¹⁷

Spender was assistant treasurer or acting treasurer during the period when Menzies held the substantive title, but felt he was 'in full charge of Treasury throughout'.¹⁸ It was Spender who presented the revised budget in November 1939 (discussed in the following essay in this series). In March 1940 Menzies formally handed over the treasurer's job to Spender.

13 His motive may have been to leave the position available as an inducement for the Country Party to rejoin a coalition; [Melbourne] *Herald* 25 April 1934; *Sydney Morning Herald* 26 April 1934. Menzies was asked by the left-wing journalist John Fisher, son of the former prime minister and treasurer, 'will you consult the powerful interests who control you before you choose your cabinet?', and replied 'naturally but please keep my wife's name out of this discussion'.; Dawes (Chapter 6, p 8).

14 *Hansard*, 12 September 1939, p 401.

15 *Hansard*, 8 September 1939, p 319.

16 *Hansard*, 8 September 1939, p 325.

17 The Economic Cabinet's terms of reference and a description of its history is given in Hasluck (1952, pp 424-435). He argues it was not a success as it was hard to isolate purely economic matters from other cabinet business.

18 Spender (1972, p 46). Supporting this view that Menzies was not that active as treasurer is that in an autobiography Menzies (1967) allocates fifty pages to the period 1939-1941 without once mentioning his work as treasurer.

The wilderness years

Having failed to bring the Labor Party into a national government, Menzies responded to division within the UAP-Country Party coalition and criticism of his performance by resigning as prime minister. Fadden then served forty days as prime minister before a change of allegiance of two independents put Labor under John Curtin into office.

Menzies eventually regained the leadership of the UAP, but by then it was only one of a number of conservative parties. Menzies succeeded in uniting most of them in a new Liberal Party, but his new party was defeated at the 1946 election.

Prime minister again

The Liberals polled well in 1949 and Menzies returned as the head of a coalition government. This time he did not want the treasurer's job for himself and Arthur Fadden and Harold Holt both served long terms in the post.

In 1942 Menzies had reflected that 'in the economic history of the last fifteen years nothing will be more notable than the rise in influence and authority of the professional economist.'¹⁹ Before his defeat, Chifley was planning to include an Economic Policy Division in the Prime Minister's Department and Menzies acted on this idea, transferring the economists from the Department of Post-War Reconstruction.²⁰ He came to adopt the Keynesian consensus. (The economic policies of Menzies' post-war governments will be covered in the forthcoming essays in this series on Fadden and Holt.)

Retirement

Menzies retired on Australia Day 1966 at the age of 71, arguably the only Australian prime minister since Barton (the first) to depart at a time of his choosing. He took to the role of elder statesman and delighted in his appointment as Lord Warden of the Cinque Ports and the associated regalia. He wrote two volumes of reminiscences in 1967 and 1970 before a severe stroke limited his abilities. He passed away on 15 May 1978.

19 Menzies (1942, p 6). He contrasted it with what he saw as the role of the statesman; to ask 'what will the people accept after proper instruction and reasonable pressure?'; Menzies (1942, p 7).

20 Lee (1995, p 127); Bunting (1998, p 77); Weller (2007).

Menzies: treasurer in transition to war

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What's new on the Treasury website

The Treasury's website, www.treasury.gov.au, includes past issues of the *Economic Roundup*. Some of the other items posted on the website since the previous issue of *Roundup* that may be of interest to readers are listed in the following section.

What's new on the Treasury website

Publications

Australia and the International Financial Institutions 2008-09

<http://www.treasury.gov.au/contentitem.asp?NavId=035&ContentID=1931>

This publication reports on Australia's interaction with the International Monetary Fund and World Bank during the 2008-09 financial year.

Tax Expenditures Statement 2010

<http://www.treasury.gov.au/contentitem.asp?NavId=035&ContentID=1950>

The Tax Expenditures Statement provides details of concessions, benefits and incentives delivered to taxpayers through the tax system.

The 2010 Tax Expenditures Statement lists around 350 tax expenditures and, where possible, provides an estimate of the pecuniary value or order of magnitude of the benefit to taxpayers over an eight year period, from 2006-07 to 2013-14.

Treasury Portfolio Additional Estimates Statements 2010-11

<http://www.treasury.gov.au/contentitem.asp?NavId=035&ContentID=1965>

The purpose of the Portfolio Additional Estimates Statements (PAES) is to inform Senators and Members of Parliament and the public of the proposed allocation of resources to government outcomes by agencies within the portfolio.

The focus of the PAES is on explaining the changes in resourcing since the Budget. As such, the PAES provides information on new measures and their impact on the financial and non-financial planned performance of agencies.

National Disaster Insurance Review

<http://www.treasury.gov.au/contentitem.asp?NavId=035&ContentID=1987>

The Assistant Treasurer and Minister for Financial Services and Superannuation announced on 4 March 2011 an independent review into disaster insurance in Australia. The Review will consider insurance arrangements for individuals and businesses for damage and loss associated with flood and other natural disasters.

The Review will be chaired by Mr John Trowbridge, with Mr John Berrill and Mr Jim Minto as members. The Panel members bring considerable experience in the insurance industry.

The terms of reference will allow a wide ranging review of natural disaster insurance. However, the Government's already initiated work with the insurance industry about a standard definition of flood and plain English in insurance contracts will proceed.

The Review Panel will consult with the public to allow for community and business input. This will include an opportunity for interested parties to make submissions to the Review. Further details of the consultation process will be provided as they become available. That will include a dedicated website and address to which submissions can be sent.

In the meantime, the Review Panel can be contacted at the following email address: NDIR@treasury.gov.au

What's new on the Treasury website

Speeches

The Resources Boom and Structural Change in the Australian Economy

<http://treasury.gov.au/contentitem.asp?NavId=008&ContentID=1975>

This address was delivered by Dr David Gruen, Executive Director (Domestic) – Macroeconomic Group, to the Committee for Economic Development of Australia (CEDA) Economic and Political Overview 2011, on Thursday 24 February 2011.

Australia 2011: Opportunities, challenges and policy responses

<http://www.treasury.gov.au/contentitem.asp?NavId=008&ContentID=1986>

This speech was given by Dr Ken Henry AC at the 2011 Giblin Lecture at the University of Tasmania, on Friday 4 March 2011.

Where are we in terms of heightened regulation and why are we here?

<http://www.treasury.gov.au/contentitem.asp?NavId=008&ContentID=1988>

This speech was given by Mike Callaghan at the Regional Symposium: Enhancing International and Regulatory Cooperation – Post Global Financial Crisis in Melbourne, on Tuesday 8 March 2011.

Consultations

The following consultations are open for public comment:

- Discussion Paper – Making tax time simpler: standard deduction for the cost of work-related expenses and the cost of managing tax affairs.
- Exposure draft – Banking Amendment (Covered Bonds) Bill (No. 1) 2011.

Past editions of *Economic Roundup*

Details of articles published in recent editions are listed below:

Issue 4, 2010

Australia's marginal tax rates, tax offsets and the Medicare levy
Measuring what we do or doing what we measure: challenges for Australia
MySuper — thinking seriously about the default option
Bank competition in the post-crisis environment
Key themes from Treasury's Business Liaison Program
Casey: the post-depression treasurer

Issue 3, 2010

IGR 2010: challenges and priorities for Australia
Tax reform: opportunities and challenges
Forecasting in the eye of the storm
Estimating the structural budget balance of the Australian Government
Key themes from Treasury's Business Liaison Program
Joseph Lyons: the Tasmanian treasurer

Copies of these articles are available from the Treasury. Written requests should be sent to Manager, Domestic Economy Division, The Treasury, Langton Crescent, Parkes, ACT, 2600. Telephone requests should be directed to Mr Pierce Lang on 02 6263 3853. Copies may be downloaded from the Treasury web site <http://www.treasury.gov.au>.

Sources of economic data

The following table provides sources for key economic data. Australian Bureau of Statistics (ABS) data can be obtained over the internet at <http://www.abs.gov.au>. The Reserve Bank of Australia information is available at <http://www.rba.gov.au>. Similarly, OECD information is available at <http://www.oecd.org>. Information on individual economies is also available via the IMF at <http://www.imf.org>.

International economy

Output, current account balance, interest rates and consumer price inflation	OECD Main Economic Indicators
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National accounts

Components of GDP, contributions to change in GDP	ABS cat. no. 5206.0
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Incomes, costs and prices

Real household income	ABS cat. nos. 5204.0 and 5206.0
Wages, labour costs and company income	ABS cat. nos. 5204.0, 5206.0, 5676.0 and 6345.0
Prices	ABS cat. nos. 6401.0 and 5206.0
Labour market	ABS cat. no. 6202.0

External sector

Australia's current account, external liabilities and income flows	ABS cat. nos. 5368.0, 5302.0 and 5206.0
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