

thebigpicture

guideposts for the private investor

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thebigpicture guideposts for the private investor is published by *thebigpicture* Economics (ABN 71 040 787 936). The author, John A Robertson, while working in Australia, London and New York, has over 20 years experience in international financial and commodity markets, corporate strategy, financial and business evaluation and government policy. He has been Chief Economist and a director of a leading Australian investment bank. He has been a top-rated institutional equity analyst and has marketed investment advice in all the major international financial centres.

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THE ACCC: IS IT RESTRAINING GROWTH?

Aggressive application of competition policy might constrain how big an Australian company can become. Ultimately, this has an impact on the type of investments available to Australian investors.

The call to protect small business and consumers sounds desirable enough. However, there is a bigger picture. Policy choices are being made based on the largely untested assumption that company profitability is necessarily contrary to consumer interests.

Several high profile decisions taken recently by the Australian Consumer and Competition Commission (ACCC) have limited the growth prospects of Australian companies. Preventing Qantas from taking a share of Air New Zealand has reduced the likelihood of a trans-Tasman airline. AGL has been prevented, as part of a consortium, from owning a share of the Loy Yang power station in Victoria and becoming an integrated energy provider.

In both these cases, acquisition of strategic stakes in other companies was seen as conferring pricing opportunities on the buyers which they would not otherwise have. If the increased pricing power was used, it was argued, the balance of market power would be tilted against consumers.

Allowing structure to determine pricing outcomes, even if this means companies failing to gain potential economies of scale, reflects an important philosophical disposition. However, it is not the only regulatory model which could be applied.

An alternative policy option is to let higher levels of industry concentration occur but to regulate the prices of the resulting corporate entities so that they are not able to sustain above normal profits. This would also protect consumers since higher profitability would depend on productivity increases and not on the use of market power to extract higher prices.

Most would regard price regulation as sub-optimal but it recognises that Australian companies are often disadvantaged by the size of their local market relative to the home markets of their peers in other industrial countries and have found it harder to achieve economies of scale and competitive cost structures.

The small local market has meant that Australia's manufacturing industries have rarely been world-class businesses. One temptation was to use various industry assistance measures to compensate. That, too, had costs. Returns from a relatively inefficient Australian manufacturing base were lower than they should have been and consumers' real incomes were reduced by tariffs and other forms of market intervention.

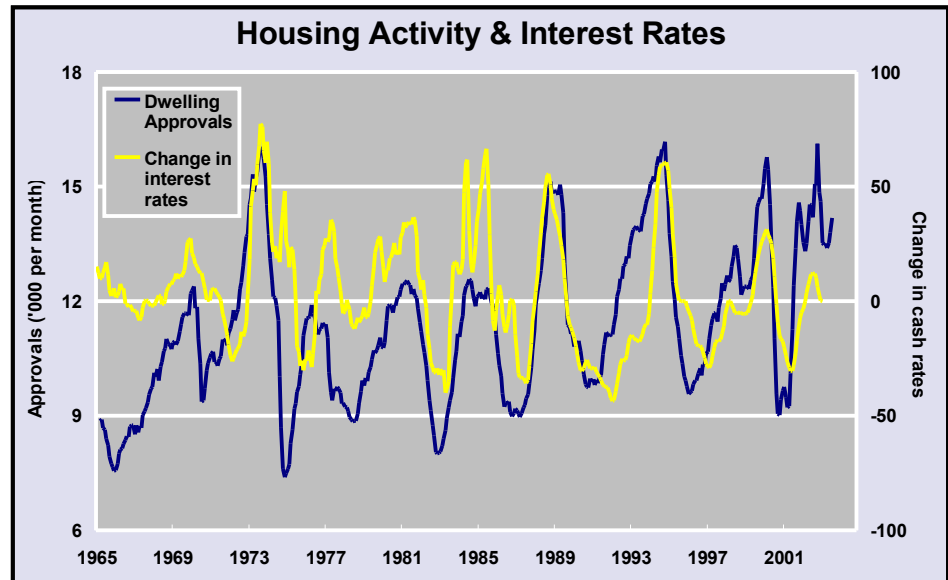
Foreign manufacturers were encouraged to relocate to Australia to help develop its industrial base. Their technological and marketing expertise allowed relatively speedy translation of business models and transfer of intellectual property. But ultimately that limited the investment choices available to Australians, unless they were prepared to incur the risks of investing offshore, and reduced Australia's income potential.

Investors in the local market have suffered a further disadvantage. Almost inevitably, Australian companies are tempted to venture offshore to find the growth which is not

"...it seems to be broadly accepted that smaller companies should be favoured by competition policy at the expense of larger companies."

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THE WEEKLY CHART SPOT



Source: Australian Bureau of Statistics and Reserve Bank of Australia

“In a world concerned with investment risk and the valuation of many financial assets, additional liquidity driven through lower interest rates has had few avenues for escape. In Australia, housing has been a logical destination given its history of relative security.”

Interest rate changes have been far less aggressive in this cycle than at virtually any time in the past forty years.

Private sector building approvals (shown in the blue line) have been supported by a relatively benign interest rate environment. Historically, the building cycle has mirrored quite closely the momentum of interest rates (shown with a lag by the yellow line) which have easily been the most important factor in the timing of turning points.

However, interest rates are being determined by non-housing related factors. That could still mean a sharp turn in the cycle eventually. Interest rates may not have to rise substantially. A withdrawal of liquidity from housing might come from fresh investment opportunities elsewhere rather than an interest rate rise directed specifically at housing.

CAUGHT BY SURPRISE, AGAIN! CONT'D

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place, the Reserve Bank might have to take action to raise interest rates. However, the speculation that rates will have to be raised quickly at the first sign of a more robust economy is wrong.

Ultimately, the only reason rates will need to rise is that inflation pressures are getting stronger. If stronger growth is accompanied by sufficiently strong productivity gains, inflation may be little affected and interest rates can remain low.

Among the matters economists have not fully understood have been how productivity growth has been able to keep a lid on inflation for much of the last decade. More open economies, the ability to source production flexibly in response to cost changes and new technology have been some of the factors. These might still be important factors averting the need for higher interest rates.

It is possible to consider two scenarios.

One is where these economic forces continue to dominate and inflation remains persistently low. With little need to raise interest rates and with new investment opportunities emerging, a better balance to Australian economic growth will be restored.

The second, less benign scenario is that capacity limitations are approached rapidly creating an environment for higher prices. If this does happen, rates will be raised in several steps. As usual, the initial extent of the necessary rise will probably be underestimated and over a period of a year there might have to be four or five interest rate rises of at least 0.25 percentage points with one or two of 0.5 percentage points.

Which of these two scenarios holds is hard to judge. Commentators who dogmatically assert that one is more likely than the other are claiming insights which actually do not exist.

THE ACCC: IS IT RESTRAINING GROWTH? CONT'D

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available locally. They have not managed the associated risks well.

Australian companies have an appallingly poor record of being able to choose off-shore acquisitions, pay a price which allows adequate returns to be achieved and then manage the newly acquired businesses.

Company growth prospects are not only affected when proposals to merge or acquire businesses are rejected explicitly. Many strategic decisions by companies are shelved because management feels that it would be too hard to get past the competition authorities.

The resources required, the business uncertainty while proposals are being considered and the impact on market values if a strategic idea is stymied are often enough to send companies in other strategic directions without testing the reaction of the regulator.

The chief executive of Foster's, for example, is on the public record as having said that the company will have to build a new brewery in Western Australia. One of its first options had been to purchase the existing brewery owned by a competitor. This plant had substantial excess capacity which could meet the needs of both companies. Foster's would have even submitted itself to price regulation to achieve the desired outcome. The slim chance of such a proposal being accepted by the ACCC was one of the reasons cited for it not proceeding.

There is allowance in the competition laws for broader interests to be considered and balanced against the competition impact. However, despite companies complaining publicly at the way the competition laws have been applied, they have been reluctant to challenge decisions legally, as they are able to do, through the Competition Tribunal. This has given the ACCC additional undefined power.

There was some thought that decisions might be more business friendly under a new ACCC chairman. The aggressive use of the media grated with some executives some of whom came to dislike personally the chairman of the ACCC for his ready resort to publicity as a policy tool.

Unfortunately, there has been some pressure on the new chairman to go out of his way to demonstrate that he will be no less

consumer friendly than his predecessor. Whether or not that pressure had an impact, recent decisions have been taken with seemingly less media in attendance and more emphasis on the facts of the case.

Despite the personnel changes, therefore, realisation of the broader strategic benefits from a transaction might be dependent on using the full range of legal remedies.

This could be a worthwhile route for companies to follow. Recent High Court decisions have applied competition rules less aggressively than the ACCC would have liked.

The so-called Boral case effectively reduced the competition hurdle for larger companies. Whether pricing was predatory, according to the court, would depend less on the effect on the competitor and more on whether the offending company could regain lost income once the competitor was removed. On this view, being unable to recoup lost income would be evidence that pricing power was absent.

So, there are some significant differences of opinion. And yet, it seems to be broadly accepted that smaller companies should be favoured by competition policy at the expense of larger companies.

The plight of smaller retailers has been especially conspicuous and has attracted political support. In the retailing industry, there have been examples of small businesses losing power to the larger retailers, to shopping centre managers and to suppliers. Ironically, when given the chance to limit retail industry concentration, the creation of a giant retailer – Coles Myer – was permitted.

As the ACCC itself concedes, it is not part of its function to provide a safety net for existing businesses. Even so, it is now widely thought of as the protector of small business as well as consumers. There is little political will to change this.

ACCC officials must follow the dictates of the law. But the full cost has never really been tallied.

Could Australians be better off with more concentrated local markets? As consumers, they might have to confront larger suppliers. But those individuals are also employees and stockholders. Who looks out for their interests? Getting this balance right should be a more explicit part of the public discussion.

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CAUGHT BY SURPRISE, AGAIN!

The Treasury Secretary made the news because of his comments that the extent of the housing boom has surprised officials. Economists, regrettably, are always being surprised.

The reality with which economists have to grapple is generally far too complex for them to understand fully. Even the most complex of models are abstractions of economic reality. While economic analysts are preoccupied on the right, something on the left changes which comes to dominate their thinking. Right now, they are preoccupied by housing price inflation because it has gone further than they had expected.

Not long ago, they were preoccupied with general price inflation. They only reluctantly conceded the merit of lower interest rates because of this overriding inflation fear. Meanwhile, there was a productivity boom which fostered a structural shift in inflation outcomes and then an equity price bubble. Neither was anticipated. And just as we were coming to terms with these effects, geopolitical issues began to dominate thoughts.

Having to respond to such changes, economists have done the only thing they are capable of: add or subtract liquidity until there is a reaction. Of course, in some cases there might not be a reaction. Japan is an example: a policy commitment to deliver whatever level of liquidity is demanded has failed to lift a stalled economy. In other cases, there might be a reaction but policy has little control over where the liquidity flows and what the reaction might be.

In a world concerned with investment risk and the valuation of many financial assets, additional liquidity driven through lower interest rates has had few avenues for escape. In Australia, housing has been a logical destination given its history of relative security.

In the past, this might have prompted a rise in interest rates. However, the non-

Taking Note of the IMF

The International Monetary Fund has spoken. How much notice should be taken? The short answer to the question is 'not much'.

The International Monetary Fund publishes periodically its review of world economic conditions. Its latest review was published in the last week.

Despite the huge reservoir of economic talent within its Washington walls, this is a task which takes many months to complete. Inevitably, when it publishes, its view of Australia and the themes to which it is drawn attract considerable press comment.

Often these views are treated as though they are a fresh analysis of the Australian situation. In reality, they are a repetition of the views and issues which prevailed in Australia several months earlier. Similarly, its forecasts of conditions in the rest of the world tend to lag behind those of other commentators.

Another constraint is a political one: IMF officials will generally prefer not to offend officials of member countries by being overtly critical in their remarks.

So, when the IMF identifies activity in the housing sector as a risk to the performance of the economy that is not new but simply reflecting a concern which first emerged in Australia several months earlier. It should not be taken to imply anything more than that.

housing part of the economy is nowhere near as robust and to have raised interest rates in the past year would have simply risked a recession which we did not have to have.

As the broader economy recovers, by definition, there will be more investment opportunities available elsewhere. In this way, funds can be drawn from housing to manufacturing, agriculture and the services and suppliers which surround them. Depending on how quickly this takes

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