Australian Services Roundtable

ASR's Response to the Productivity Commission draft report on Australia's Export Credit Arrangements, April 2011

The Australian Services Roundtable is the peak business body for the services industries in Australia. Sectors represented include financial services (banking, insurance, securities, fund management), professional services (accounting, legal, engineering, architecture), health services, education services, environmental services, energy services, logistics, tourism, information technology, telecommunications, transport, distribution, standards and conformance, audio-visual, media, entertainment, cultural and other business services.

Thank you for the opportunity to provide a supplementary submission and to discuss the draft report at the public hearing. This submission will not repeat information already provided in ASR's original submission and points made at the Canberra public hearing.

ASR strongly endorses EFIC's response to the draft report, in particular the evidence provided by EFIC and in other submissions that EFIC in its commercial account appropriately operates as a commercial business, but in a market gap not serviced by other financial services providers, and does not provide a subsidy to its clients.

ASR strongly opposes the use of subsidies in international trade and supports the Australian Government's advocacy to reduce their use, including in discussions being held in the WTO on an International Services Agreement.

In this context the draft report's suggestion that EFIC provides a subsidy is serious charge to level and damaging to Australian advocacy. Even though the draft report does not impute any dollar value for the 'subsidy', given the prominence of the discussion many readers might conclude the Commission considers it may have a significant dollar value. The evidence provided by EFIC and in a range of submissions refutes the suggestion that there is any subsidy. Greater clarity on this issue would be provided by the final report making a comparison of EFIC's operations with those of other Export Credit Agencies. ASR would be concerned if EFIC was not performing at above the median level, but we do not believe that this is the case. Such a comparison would also be useful in support of advocacy on reforming OECD and WTO guidelines on the operation of ECAs to lower the use of subsidies.

The draft report places much emphasis on market failure as the basis for government intervention. In fact market failure is commonplace, including in relation to export credits and export markets more generally. The existence of market failure does not of itself justify government intervention. For example, attempts to address market failure through export subsidies have shown that it is very difficult for governments to apply disciplines to these subsidies, and Australian business would be far better off if they were eliminated from international trade. Equally there are good reasons why EFIC should not compete with private sector providers of credit.

The draft report states: "*In the absence of evidence of failure in financial markets (that are best addressed by the provision of export finance and insurance), there is no reason why EFIC should take on transactions that the private sector considers will not generate an expected return (given the risk incurred) that is high enough for that firm to take on*."

Thus the draft report suggests provision of export credit is a 'second best' option as while there may be market failure in access to capital by exporters (for example, as a result of information failures, tariffs and subsidies), these failures can be addressed 'at the source'; eg by the provision of information, removal of the domestic subsidies, etc.

The case for the provision of export credit to be considered second best is weak on the basis of the analysis currently provided in the draft report.

For example, the draft reports suggests the provision of information, presumably without any responsibility in the case of that information being faulty, is a first best option. It is not clear how useful such a service would be to the domestically oriented financial institutions who currently often fail to provide credit for exporters, and whether quality staff could attracted to the government body responsible for performing this task.

There are also tax incentives, guarantees, subsidies, and the four pillars policy related to the domestic financial services industry, and also a number of remaining tariffs which encourage domestic industry at the expense of exports. The issues involved are complex and would widen the scope of the report unreasonably were they to be discussed, especially considering the presence or absence of EFIC is unlikely to make a difference to policy reform in these areas.

For example, Australian exporters would receive better support for export finance when the banks that typically service their financial needs improve their capabilities. The policy framework that has locked in place four strong domestic banks has not been helpful in building the international linkages and credit assessment capabilities needed by Australian exporters; however reform of Australian banking involves issues beyond export credit.

This analysis suggests that, given current policy settings, market failure in relation to exporting is widespread, is likely to impact both small and large firms and the possible ‘first best’ solutions are beyond the scope of assessment reasonably possible in this review.

The draft report states that a “*focus on large, publicly listed companies does not assist those exporters most likely affected by inadequate information and impediments to accessing export finance — newly exporting SMEs*”.

It is true that the market gap addressed by EFIC provides cover for only a relatively small proportion of exporters. This is a feature of many policy instruments. For example, a drink driving campaign will not eliminate drink driving but may reduce it, and may be ignored by the heavy drinkers most likely to cause problems. Similarly EFIC cannot eliminate market failure for all firms exporting, but can reduce market failure in relation to a set of clients that can be serviced commercially (ie without subsidy) and without competing with commercial financial services businesses. It is an example of the *Nirvana Fallacy* to consider that the practical limitations on any one institution or policy in addressing a problem are grounds for abandoning the policy/institution.

There is no more evidence to support the contention that the market failure rationale for export credit evaporates after three uses of EFIC’s services, than the view that three drink driving messages should be sufficient to combat drink driving.

Similarly no theoretical or other evidence is provided to support the contention that market failure is more likely in newly exporting SMEs. OECD and WTO rules regarding the operations of ECAs do not identify SMEs for special treatment. While newly exporting SMEs do find it difficult to obtain export finance, the most obvious reason is not market failure but simply that they present a higher risk of default than more established and larger exporters. Also regardless of size any new corporate risk assessment involves some establishment costs. These fixed costs may be too high for some small firms to be profitably serviced. To provide support for its recommendations that EFIC should downsize its definition of SMEs and shift its focus to SMEs in response to market failure, the final report should show that it has accounted for these non-market failure effects.

ASR does support increased efforts by EFIC to address SMEs, but this should not involve EFIC operating outside the existing ‘market gap’ in which it operates or reducing its service to large exporters. EFIC has a number of products to service SMEs, including the Export Working Capital Guarantee (EWCG), bonds, foreign exchange guarantee, and the producer offset loan. The EWCG product is designed to work with the banks in order to service SME exporters and it has seen EFIC’s support for SMEs grow significantly. The ANZ submission notes that EFIC is currently exploring the possibility of extending the Working Capital Guarantee into a product offering for the Small Business sector (akin to a micro finance offering for small or fledging exporters). This would follow models successfully delivered in some European countries. ANZ is working with EFIC to see if this can be practically offered to the Australian market place. ASR believes that EFIC should continue to work with the private sector to increase its coverage of SMEs.

Given the historically poor record by Australian banks in providing export credit to SMEs, (exporters ASR has talked to claim that the Australian banks' willingness to extend export credit is notably worse than in other developed countries) there are ample opportunities for interaction by those banks with EFIC to help improve their performance.

ASR notes that recently at least one of the four major banks has started to advertise its capabilities in supporting Asian region business expansion – a major step forward. Determining causality in these cases in always difficult, but the evidence from submissions indicates EFIC has been helpful in the process of increasing international knowledge and capabilities of the domestic banks. That such knowledge flow would occur is in accord with theory and evidence from a wide range of studies on business knowledge diffusion. EFIC's position as a 'commercial operator' enables a flow of staff with private sector export credit providers, a key vector for complex knowledge transfer.

ASR notes that EFIC has provided ample evidence that it 'crowds in' rather than 'crowds out' private sector export credit, and that this view is strongly supported by submissions including from private sector financial institutions. No financial institution has provided any example of EFIC 'crowding out'.

Draft Recommendation 8.3 calls for the pricing of EFIC's commercial account transactions to reflect the full economic cost, including a commercial rate of return reflecting risk that is benchmarked against that of appropriately selected private sector providers. This recommendation fails to take into account the institutional role and obligations that EFIC has as a Government business. For example, EFIC provides value to the Government through the provision of its skills, advice and management of the national interest account and to adequately undertake this role requires a critical mass. There are also higher costs associated with being a Government agency, including a range of accountability measures. These are an unavoidable responsibility of Government, but do not seem to be factored into the draft report's analysis.

A similar oversight about of the cost of accountability is shown in a number of the draft recommendations that if implemented by the Government would increase EFIC's cost base, eg 8.4, 9.2, 9.3, 9.6, 9.7, 9.8. Given that EFIC operates in a narrow band of commercial operations that the private sector does not want to service, any increase in the cost of accountability requirements will reduce its capacity to service its existing clients, and taken to an extreme has the potential to make EFIC's operations non-viable. Just as is now the expectation in the case of new regulation, cost-benefit analysis needs to be applied to any additional administrative costs proposed to be imposed on EFIC. In none of these recommendations has the case been made that the benefits exceed the costs.

ASR opposes draft recommendation 9.1 that the Department of Foreign Affairs and Trade should no longer be represented on the EFIC Board. This recommendation fails to take full account of the institutional role of EFIC and the importance of its interactions with Government at a number of levels, including at Board level.

ASR is not aware of any sound economic evidence to favour one sector of the economy over another, and that overwhelmingly the economic evidence is that competition, including from foreign exporters, is beneficial as it stimulates innovation and productivity. Just last year, the Australian Bureau of Statistics and the Productivity Commission published the report *Competition, Innovation and Productivity in Australian Businesses*. A major finding was that:

"having more competitors, having a lower price-cost margin (a measure of mark-up over cost), being an exporter, and reporting downward pressure on profit margins in order to remain competitive, are all associated with a significantly higher probability of being an innovator."

The final report should have a stronger discussion about competition, innovation, productivity and international engagement. In places in the current text the points being made are not clear.

For example on p68 the draft report states:

In other cases, policies that support the export of services may enhance the competitiveness of foreign companies that directly compete with Australian exporters. This could be the case, for example, where support is given to overseas mining projects that compete in international markets with Australian mines.

The final text should make clear to the reader the benefits from such services exports to Australian innovation and productivity, including in mining.

And on p69 it states:

For example, if production leads to innovations that will provide wider benefits not captured by the producing firm, it would be more efficient to directly subsidise the source of the externality — the production of the good or service — particularly as it makes no difference whether or not the good or service is exported.

The final text should make it clear that it makes an enormous difference whether a good or service is exported as the global market is typically fifty to one hundred times the size of the Australian market, and the cost of the initial innovation in many instances is high relative to the variable costs associated with expanding market size, eg IT services. As there are well documented market failures that inhibit the access of Australian innovators to global markets, including the difficulties in accessing global supply chains, production subsidies generally would seem to be a less efficient way of addressing the market failures typically faced by innovative Australian businesses.

Given that most services exports are channelled via overseas affiliates, the view of the draft report that there "*appears to be no market failure affecting Australian exporters wishing to invest overseas*" is prejudicial to services exports and does not seem to be based on any evidence or economic analysis. The major mode of services exports is via foreign commercial presence, ie overseas investment.

The Commission's thinking on this issue may be assisted by the report of a series of workshops ASR conducted with services exporters across a wide range of service sectors. The report is available on the ASR website www.servicesaustralia.org.au

The report shows that many services exporters use all four modes of exporting and dynamically move between the modes according a range of factors, costs, availability of skills, regulation etc. The use of mode 3 (commercial presence), even by relatively small services exporters is increasingly common. Imposing conditions on the use of mode 3 exporting would reduce business flexibility and therefore significantly reduce the value of EFIC to services exporters.

ASR questions the view that there are no market failures in relation to foreign investment:

- there are a range of risks in operating in foreign markets, especially Asian, markets that Australian domestic banks typically do not have good information about and where EFIC may have relevant knowledge ie 'the market gap'

- at a macro level this effect is readily observable in the foreign investment data where Australian investment is heavily concentrated in markets such as NZ, UK, US that Australian banks are comfortable with:

    - it might be said that this is not market failure but simply a fact associated with risk, banks don't like to fund o/s expansion in risky markets, however Australian companies have been notably more cautious investing in Asia than North American and European companies, suggestive of lack of risk assessment capability more than lack of sound investment opportunities – and a possible role for EFIC in some instances.

        - EFIC by itself is not capable of fully addressing this issue (otherwise the investment data would not be as it is)

      - EFIC may not have the information available to larger US and EU firms and their banks (and ECAs)
      - EFIC may be too small to cover the risks involved
      - EFIC's potential customers may be too small to cover the risks involved
      - the fact that EFIC's intervention is small relative to the problem does not mean EFIC's existing activities are not worthwhile, it is part of a suite of export enhancing measures that are slowly working on this issue, and it is not always practically possible to efficiently address market failure;
   - there is a need for a range of policy measures in relation to the Asian Century – the Government has accepted that with the Ken Henry review to which ASR has made a submission.
- There is no reason to expect that when exports need to be channelled through a foreign subsidiary that market failure factors that exist for ordinary exports would suddenly disappear (eg when a law or engineering firm moves from fly-in fly-out provision of services to establishing a local presence, if anything logic would suggest that foreign investment and company establishment poses new risks for banks relative to dealing with an 100% Australian entity.

In summary, ASR's view is that EFIC has an important role in the suite of Australian government measures to address market failure in relation to international business and that for the most part it operates under an appropriate set of administrative arrangements. ASR supports the comments made by members such as Consult Australia and King & Wood Mallesons expressing their concerns about the draft report. The draft recommendations if implemented would severely damage EFIC capacity to undertake its task.

Rather than curtailing EFIC's role, recognising the range of international business arrangements associated with global supply chains and services trade, the final report should recommend increased flexibility for EFIC to support business engaged in international business in this way within the scope of its defined "market gap".

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