Unravelling Intervention in the Wool Industry

CIS Policy Monographs 17

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THE CENTRE FOR INDEPENDENT STUDIES
1990

Published November 1990 by

The Centre for Independent Studies Limited

National Library of Australia

Cataloguing-in-Publication Data

Watson, Alistair, 1936-
Unravelling intervention in the wool industry.

Bibliography.
ISBN 0 949769 61 4.

1. Wool industry — Australia. 2. Wool industry — Government policy — Australia. 3. Agricultural subsidies — Australia. I. Centre for Independent Studies (Australia). II. Title. (Series : CIS policy monographs; 17).

338.17631450994

Cover design by Hand Graphics

Printed by Griffin Press Limited, Marion Road, Netley, South Australia

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Foreword

READERS of this monograph will obtain an excellent appreciation of the economics and politics of the Reserve Price Scheme (RPS) for wool and its effect on the wool industry. The author, Alistair Watson, is one of Australia's outstanding agricultural economists, destined to become a doyen of his profession for his insightful analytical work on the marketing of agricultural products. This monograph will add further to his stature.

It can be safely predicted that the monograph will not win friends for Dr Watson or his profession amongst those who have a penchant for 'shooting the messenger' in the mistaken belief that ignorance will protect them from the outcome of events. It is frustrating to have to address clear, analytical argument when you are armed only with political rhetoric. However, such is the position of those in the wool industry who have been defending their actions during 1986-89 when the reserve price for wool rose by some 70 per cent. It was over this period that this RPS was transformed from a buffer stock scheme designed to stabilise prices into a speculative reserve scheme with the implicit strategy of raising the long-term price of wool. This was done without analysis or debate, and in many quarters of the industry probably even without knowledge of such a strategic move.

It could be argued that it is easy to be wise and analytical with the benefit of hindsight. But Dr Watson reminds us that there were plenty of warnings about the possible sequence of events that could lead to the reserve price being set too high, with disastrous results. He cites the work of Dr Jack Duloy and Professor Ross Parish, who in the mid-1960s conducted research into the viability of a reserve price for wool. They were very sceptical about the likelihood of its success and with some prescience suggested:

> There is thus the risk that because of errors of judgment on the part of the authority, or because of pressure from dissatisfied groups of growers, a conservative scheme would escalate into a radical one.

I can recall a vigorous public debate, about that time, at the University of New England between on the one hand Sir William Gunn and the recently-appointed Managing Director of the International Wool Secretariat, Bill (now Sir William) Vines, representing the Australian Wool Board, and on the other hand Jack Duloy and Ross Parish, representing academic sceptics or economic rationalists (depending on your point of view). It was a healthy and open debate with plenty of audience participation from both woolgrowers and academics. It is interesting to note that Sir William Vines now heads the Commonwealth's Review of Wool Market Arrangements; one hopes that he can use the experience of that controversy of 25 years ago to good effect in the current inquiry.

Unfortunately, such is the dogma associated with the RPS that many in the industry still do not accept or recognise that the price of 870 cents per kilogram was too high and that, with the continuing accumulation of stocks, even 700 cents may be too high. The naive in the industry are wishing for the laws of supply and demand to be suspended, while the more sophisticated are justifying their stance by appealing to strategic trade theory with its attractive but improbable outcomes.

Dr Watson, who was briefly employed by the International Wool Secretariat in the early 1970s, gives a thorough economic appraisal of the pros and cons of the RPS and the risks facing those who administer such schemes. He takes the reader through the history of the RPS, giving an appreciation on industry politics and an understanding of the institutional arrangements that led to the outcome we observe today. Examining as it does, in the context of the RPS, issues as wide-ranging as equity effects on different types of woolgrowers, effects of exchange rates on forecasting, income stability as opposed to price stability, a strategic export tax, and the effects on other woolgrowing countries, Dr Watson's analysis in embedded in the institutional and political fabric of the wool industry.

Though critical of many aspects of the RPS and its administration, Dr Watson does explore the benefits that the RPS could deliver. On balance, I believe his analysis is a fair assessment of the scheme and the events surrounding it. But readers should form their own judgments.

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Acknowledgements

The author would like to thank the anonymous referees for their many useful comments and Michael James for his assistance in reorganising the original draft of the manuscript, which was written before, during and after the recent controversy in the Australian wool industry. The author would also like to thank J. H. Duloy, J. N. Lewis and R. M. Parish for teaching him about the issues in the first instance.

About the Author

Alistair Watson is a freelance agricultural economist based in Melbourne. He has previously worked for the Australian Bureau of Agricultural and Resource Economics, the University of Melbourne and the International Wool Secretariat. He has been President of the Australian Agricultural Economics Society and Editor of *The Australian Journal of Agricultural Economics.* Dr Watson served as part-time Associate Commissioner for two inquiries of the (then) Industries Assistance Commission. He has published several papers on the pricing and marketing policies of Australia's major agricultural industries, and contributed to the CIS Policy Forum *The Economics of Bureaucracy and Statutory Authorities* (1983).

This degradation both in the real and nominal value of wool, could never have happened in consequence of the natural course of things. It has accordingly been the effect of violence and artifice . . .

Adam Smith, **The Wealth of Nations**

Chapter 1

Introduction

BUFFER stock schemes are intended to stabilise prices through transactions in stocks. To paraphrase Duloy and Parish (1964:5), the basic aim of the authority operating any buffer stock scheme is to buy the commodity when it is cheap and to sell it when it is dear. The effect of such a policy, successfully pursued, would be to raise prices when they are low and lower them when they are high. In this way, the scheme would exert a stabilising influence on commodity prices; it would also be essentially financially self-supporting. Such a scheme has operated for the Australian wool industry since 1970, although the main ingredients of the present scheme were not settled until 1974.

The Terminology of Australia's Wool Marketing Arrangements

Unfortunately, the terminology surrounding Australian wool marketing arrangements is somewhat confusing. Although the reserve price scheme (RPS) was intended to resemble a typical buffer stock scheme, it has seldom been described as such. The term 'reserve price' describes in effect the instrument of intervention that initiates the cycle of stock-holding operations. Sometimes the term 'floor-price scheme' has been used interchangeably with RPS; but there has never been provision for an announced 'ceiling price' to determine when stocks of wool would be released. (In fact, the procedures to be followed for disposal of stocks are poorly defined and seldom discussed. This is one of the more important deficiencies of the RPS.) More recently, the scheme has often been called the 'minimum reserve price' scheme (MRP), to distinguish normal buffer stock operations from the additional purchases of stocks sometimes undertaken by the Australian Wool Corporation (AWC), at prices that are well above the floor ('flexible' reserve prices).

The Declining Reputation of the RPS

Buffer stock schemes have a chequered history internationally, and their frequent failure has been attributed to a mixture of conceptual and administrative difficulties (Gardner, 1985). Storable commodities like wool are subject to peaks in prices when unforeseen increases in demand, or shortages of supply, leave stocks insufficient to moderate price rises (Wright & Williams, 1990). The danger for a buffer stock scheme is that the reserve price follows these peaks upwards because the managers of the scheme regard the change as permanent.

Until recently, the Australian wool industry kept out of trouble and the RPS has been regarded as an example of successful price stabilisation. The main explanations for the relative success of the RPS are, first, that world demand for wool was reasonably stable from 1974 to 1986, and second, that satisfactory prices for cereals until 1985 reduced the production of wool. The good reputation of the RPS was seriously challenged by the rapid accumulation of stocks from the middle of 1989, which followed a 70 per cent increase in the reserve price after an unexpected boom in prices. The reserve price was raised by 70 per cent over two years: from the 'market indicator', or weighted average, price of 508 cents per clean kilogram in 1986-87, to 645 in 1987-88 and then 870 in 1988-89. These developments coincided with administrative changes that gave woolgrowers more power in setting the reserve price.

In the political controversy that surrounded the forced lowering of the guaranteed price to 700 cents per kilogram in May 1990 by the Minister for Primary Industries and Energy, Mr John Kerin, conflict over the appropriate roles of government and industry in determining the reserve price often seemed more important to woolgrowers than did the economic effects of the decision. The conflict was also described by some in the wool industry as a dispute between economists in different agencies whose views allegedly held sway with the Minister, and the superior commercial and marketing judgments of the practical men closer to the AWC and the Wool Council of Australia (WCA). Perhaps this was understandable in the heat of the moment following the controversy over the reserve price, but the chairman of the AWC, Mr Hugh Beggs, complained that the Minister had favoured advice from 'a bunch of bureaucrats and purist economists with little or no commercial or marketing experience' (*The Australian Financial Review*, 1 June 1990, p.3). In fact, many economists would regard the underlying ideas in contention as reasonably straightforward and are probably being flattered by the designation 'purists'.

Buffer stock schemes are usually initiated in response to pressure from producers during slumps in commodity markets. The RPS was no exception. As it happened, there was a rapid recovery in the wool market in 1972 and 1973 and stocks were able to be cleared profitably. The boom in wool prices could have been explained by straightforward economic factors: notably an undervalued Australian exchange rate at the time, inflationary developments in the world economy that triggered a widespread boom in commodity prices, and, most important, the sharp decline in Australian wool production of about 20 per cent that was associated with very low prices from 1969 to 1972. Similarly, the earlier slump in the wool market which brought about the introduction of the RPS was also explicable in terms of economic fundamentals (Watson, 1973).

Nevertheless, most woolgrowers, inevitably and unfortunately, were convinced that the dramatic change in their fortunes was mainly due to the RPS. Another important legacy of this initial success was to silence critics of the RPS, inside and outside the wool industry, whose arguments had been persuasive enough to win over the majority of woolgrowers who voted against the introduction of a buffer stock scheme in the referendum of 1965. Consequently, although the introduction of the RPS was preceded by a vigorous and informed debate, its economic rationale and performance have not been seriously questioned in agricultural and political circles for the last 20 years.

The Need for Debate

In many ways, the Australian wool industry has become entrapped in myths surrounding the RPS. Positions of power in the wool industry now depend upon enthusiastic acceptance of the RPS and the policies of the AWC. This is not healthy, especially for the AWC. Just as there are costs in attempting to transform an uncertain prospect — like the price of wool — into a certain prospect, the elevation of any instrument of economic policy to the status of an article of faith, rather than a matter for empirical investigation and detached questioning of its theoretical basis, will eventually have its day (or month) of economic and political reckoning. This happened for the Australian wool industry in May 1990.

Earlier controversy over wool marketing took place between advocates of intervention, euphemistically described as 'orderly marketing', and advocates of *laissez faire* (Watson, 1980). These differences in attitudes have now largely disappeared, partly because of the apparent success of the RPS, but also because the amalgamation of farm organisations into a peak organisation, the National Farmers'

Federation (NFF), has submerged differences among farmers based on regional, commodity or ideological differences. As predicted by Campbell (1980), this has diverted the NFF from concerns with price and marketing policies affecting individual commodities to more general issues affecting farmers, such as taxation, trade and the macroeconomy. Farmers have also been coopted into the politics of consensus, conformity, accords with the Australian Conservation Foundation and the like, as distinct from the previous pluralistic system that was able to reflect a wide range of attitudes and economic interests.

The Australian wool industry is in need of an open debate about the contemporary relevance of the RPS and the arrangements that determine its links to government. One of the problems of current institutions is that they foster the pretence of an 'industry' view, when in reality woolgrowing farms (and farmers) are highly diverse. It is of the nature of political organisations that they find it difficult to recognise error, let alone admit or correct it. The paralysis of policy making in the wool industry, and the failure to come to terms with events in the market, eventually resulted in events passing from the immediate control of woolgrowers' organisations.

The remainder of this monograph is organised as follows. Chapter 2 describes the workings of the RPS, including the operations of the Market Support Fund. Chapter 3 introduces some of the difficult issues arising from the ambiguous relationship between the government and the wool industry in the management of the RPS. Chapter 4 describes the nature of the supply and demand for wool and how changes in the economic environment have affected the RPS. Chapter 5 provides further information on the economic rationale for buffer stock schemes in the context of the Australian wool industry. Chapter 6 deals with the controversy over the lowering of the reserve price; in particular, the alternative policy proposed by the wool industry, which relied on marketing initiatives and expanded wool promotion. The conclusions of the study are presented in Chapter 7.

Chapter 2

How the Reserve Price Scheme Works

THE basis of the RPS is a minimum or 'reserve' price at which the AWC purchases wool that is not bought by the trade at auction. Since it is unlikely that a buffer stock scheme could increase the incomes of producers over a cycle of operations (because the price-raising effects of purchases will be offset, more or less symmetrically, by lower prices when stocks are sold), buffer stock schemes should be considered mainly in terms of their effects on moderating the extreme price fluctuations that are faced by both the producers and the consumers of many storable commodities.

The RPS as a Form of Speculation

Although the RPS has often been given other justifications, some of which are to be briefly discussed later in this monograph, the RPS is, above all, a form of speculation that aims to stabilise the price of wool. Consequently, the key to a successful buffer stock scheme is the establishment of a price that balances production and consumption in the long run. The obvious danger is that the price will be set too high, in which case stocks accumulate until capital is exhausted, and stocks have to be disposed of at lower prices. This danger can be avoided only if reliable forecasts are made of commodity prices and, additionally, if institutional arrangements allow those forecasts to be translated into decisions by the buffer stock authority.

Like all speculation, the success of the RPS depends upon the accuracy of forecasting. Contrary to popular opinion and the ignorance and self-promotion of some economists, the discipline of economics does not teach that prices can be forecast in well-functioning markets; quite the contrary. Empirical research supports the 'random walk' or 'efficient markets' theory of price formation in commodity, financial and share markets. The substance of this theory is that prices should already reflect available economic information on forthcoming supply and demand so that the next change in price cannot be anticipated.

The ability to forecast successfully, therefore, has to depend upon the analyst having access to more timely information, or a better understanding of price relationships, than do other market participants.

As it happens, the Australian wool industry has access to commodity outlook and information services of very good quality. Politicisation of decisions about the reserve price significantly diminishes the usefulness of these resources. The AWC is assisted by its links to the International Wool Secretariat (IWS), which has a network of branches and good contacts with the wool trade. But the IWS has always had an unfortunate tendency to exaggerate prospects for demand, since its success in wool promotion has often been judged, completely erroneously, by the short-term state of the wool market. The predictable optimism of the IWS has been uncritically accepted by many in the wool industry and the rural press over the years, with most damaging consequences in recent times. The IWS also has an unfortunate history of playing to the crowd in debates over wool marketing, which ought to have done more damage to its credibility than is the case (Lewis, 1979, 1981).

Until 1989, when stocks began to grow rapidly, substantial financial losses were avoided by the Australian wool industry. The reserve price was set conservatively until 1986-87 and a reasonable link was maintained between reserve prices and market prices. Nevertheless, recent events have confirmed in most striking fashion the doubts of early critics of the RPS that wool prices could be successfully forecast and that all sections of the wool industry would be permanently satisfied with a conservative RPS (Parish, 1964; Duloy 1965; Duloy & Parish, 1964). In fact, Duloy and Parish had concluded (in part) their theoretical and empirical analysis of prospects for a RPS in the 1960s as follows:

> Even a conservative reserve-price scheme would run some risk of getting into difficulties. Furthermore, because of the limited achievements of a conservative scheme, the supporters of a floor-price scheme are likely to demand a more radical reserve price. There is thus the risk that because of errors of judgment on the part of the authority, or because of pressure from dissatisfied groups of growers, a conservative scheme would escalate into a radical one. (1964:30)

The Market Support Fund

Since 1974, a tax has been levied on woolgrowers to finance the RPS through the Market Support Fund and to pay for research and promotion. This set the wool industry apart from most price support and stabilisation measures for agricultural products in developed countries, which are usually financed by consumers and taxpayers. Conversely, many stabilisation arrangements for agricultural commodities in poor countries have favoured urban consumers at the expense of peasant producers. The Market Support Fund is a revolving fund that aims to hold a third of the value of the annual clip to finance purchases of stocks, with new contributions enabling (nominal) refunds to be made to earlier contributors. There is therefore a variable lag between collection and refund of the tax. At present, the fund is exhausted following the large purchases of wool during 1989-90. Borrowing became necessary to finance AWC stocks around the end of 1989.

The introduction of this tax gave the RPS some features of both a standard buffer stock scheme and a buffer fund scheme, where prices and incomes are stabilised by transferring receipts over time through taxes at times of high prices and refunds during slumps. In practice, current arrangements, which are like a de facto banking system for woolgrowers operating under arbitrary rules, have destabilised rather than stabilised incomes. This is because refunds have been concentrated at times of high rather than low prices. In fact, refunds from the Market Support Fund were made in the second half of 1989, at the same time as the Fund was being used to finance the increase in wool stocks.

As recent events have demonstrated, the wool tax is a source of conflict within the wool industry. The rate at which the tax is set affects the ratio of debt to equity in the value of stocks held by the AWC. Because the ability of producers to substitute between enterprises varies across the sheep industry, the wool tax has distributional effects on woolgrowers. In particular, specialist wool producers are favoured by equity financing of stocks rather than debt, since, in the event of insolvency of the RPS, those who are able to leave the industry would not be committed to pay future debts. In effect, financing stockholding by the wool tax rather than by debt means that the distribution of any financial losses reflects more closely the distribution of the gains that are achieved (temporarily) through higher prices.

There should be agreement that whatever taxation system is desirable in an economic sense, or reflected in the political preferences of the community, its design and administration should be the province of government, not the WCA or any other sectional group. It is inevitable that decisions taken on the basis of majority opinion in the

WCA cannot be in the interests of all woolgrowers, and will give even less weight to the interests of others.

The situation in the wool industry has also raised issues of wider interest, including effects on public sector borrowing requirements and the temporal distribution of export revenue from wool. The wool industry is still too important in the Australian economy for its problems to be left entirely to the political processes of producer organisations. The virtual transfer in 1987 of the power to set the reserve price from government to the WCA was perhaps the most politically contentious and momentous event in the recent history of rural policy in Australia, at least until the recent controversy over the reserve price.

Despite the long history of producer and political support for the RPS, the rates of tax that became necessary to maintain the financial viability of the RPS implied such drastic effects on the incomes of wool producers that the bipartisan political support enjoyed by leaders of the wool industry since the introduction of the RPS was seriously challenged. An interesting aspect of recent events was the implicit support given by the Liberal Party to the policies followed by Mr Kerin, at some cost to their relationship with the National Party, who followed more closely policies espoused by the wool industry. This has important long-term consequences for the wool industry and the RPS.

While wool is an interesting case study of price stabilisation, the first test that should be applied to the RPS should be based on an evaluation of its financial effects on woolgrowers. This is because it is a grower-funded scheme. This requires making a judgment whether, at the previous reserve price, prospective purchases by wool users would have been sufficient to absorb expected production, and whether production would fall sufficiently in the future to allow a reduction in the stocks held by the AWC, which involve such substantial carrying charges. It also requires making a judgment whether woolgrowers are better-off holding a major portion of their assets as stocks of wool rather than in other forms. Essentially, the wool industry has had to decide between lowering the reserve price and/or increasing the wool tax to solve its difficulties. But first it will helpful to try to explain how this potentially disastrous situation developed.

Chapter 3

Control by Industry or by Government?

UNTIL recently, the government preferred to leave the wool industry and its institutions to their own devices. This was despite the recognition that buffer stock schemes can succeed only if there is careful attention to the method of setting the reserve price. This distancing of government from the wool industry was justified by successive administrations by reference to statutory bodies' alleged need for freedom from bureaucratic interference in functions that, in reality, can be carried out only under powers provided by government. Sometimes the argument was put in terms of the need for the AWC to be more 'commercial'. It is as difficult to argue with that superficially attractive objective as it is to understand its precise meaning.

The Politics of Statutory Marketing Authorities

There are long-standing arguments over the appropriate role of statutory marketing authorities, such as the AWC, in Australian agriculture. Primary producers and their organisations appear to see statutory marketing authorities as responsible to them, and, in many cases, this has been the legislative intent of governments. A central feature of all these bodies is the compulsory power that is conferred by legislation. As most powerfully demonstrated by Sieper (1982), it is not surprising that the overwhelming preoccupation of statutory marketing authorities is with distributive questions, rather than economic efficiency in the performance of their functions.

Many attempts have been made to redesign marketing boards so as to reconcile the inherent conflict between the pursuit of economic efficiency and the domination of boards by producer representatives, who will inevitably be preoccupied by short-term political agendas as they seek to placate their constituents in farm organisations and keep the peace with politicians on whose favours their powers depend. Most of these efforts at reforming marketing boards have had only varying degrees of success to date. The most recent thrust in this direction (Miller, 1984) has sought to remodel the boards along the lines of joint stock companies. At the very least, this would seem to be inconsistent with the notion of compulsory participation by producers. It is interesting to note that the wool industry seems to have been exempted, presumably because of its special political influence, from useful recent reforms to statutory marketing authorities that have been based on some of the better ideas in the paper by Miller. For example, responsibility for research and development for the wool industry has stayed with the AWC, with continuing conflict and confusion between the research and marketing objectives of the organisation.

Recent events suggest that it was naive to expect that a body like the AWC, which was dominated by the influence of woolgrowers through the WCA, could take a long view of the economic forces at work in the Australian and world wool industries. This conclusion was eventually forced on Mr Kerin, the architect of the wool marketing legislation of 1987, who conceded that:

> I made a mistake in believing the Corporation was strong enough to take purely commercial decisions about fundamental commercial issues such as the level of the MRP. I did not foresee the industry political pressure put on grower members of the Board to push up the price. (Kerin, 1990:2)

Modern McEwenism

There was a fine dividing line between the preferred arms-length approach of the present government to decision-making in the wool industry and ideas on the appropriate relationship between producers, statutory marketing authorities and government that are associated with Sir John McEwen, the former leader of the Country Party. These ideas, often known as 'McEwenism', can be summed up thus:

> My attitude is that neither the Australian Country Party or its parliamentary members should decide what is the correct policy for a primary industry. It has always been the policy of my Party that those who produce, own and sell a product are the best judges of the way in which their own property should be treated. It is the function of my Party to see that the will of those who produce and own the product is carried into legislative and administrative effect... (Commonwealth of Australia, 1965)

The almost syndicalist flavour of that statement is matched by the following extract from the second reading speech in April 1987 on the 1987 Wool Marketing Bill by the Minister representing the Minister for Primary Industry:

> At present the Minister for Primary Industry determines the market indicator floor price each year for the reserve price scheme. This is inconsistent with the Government's objectives of maximum commercial flexibility and autonomy. Accordingly, the bill provides for the AWC, as the commercial operator, to set and announce the minimum market indicator reserve price and the reserve prices for the various wool types, after agreement with the WCA on the minimum market indicator price. This arrangement recognises not only the commercial role of the AWC but also the role of the WCA in representing the wool growers who provide the funds through a tax paid on the shorn value of wool sold. If the AWC and the WCA are unable to agree, the Minister will determine and announce the minimum reserve price for that year. (Commonwealth of Australia, 1987)

Although formally the reserve price was still set by the Minister in 1987, this happened when ministerial responsibility was in the process of being abandoned in favour of producer control, which certainly did not encourage caution. The euphoria and optimism engendered by the boom in 1987 and 1988 has been fully described in a comprehensive account prepared by the consulting firm ACIL (1990). The study convincingly demonstrates how economic judgments took second place to political pressure for higher prices, based on traditional claims for income support and cost-based pricing. Perhaps the ACIL report was a little optimistic in its assertion that the WCA would benefit from having access to its own sources of independent economic advice. One of the more lasting impressions from the recent controversy over the reserve price is how some leaders of the wool industry remain, in John Stone's words, 'totally free, one must presume, of any taint of being economically educated' (*The Australian Financial Review*, 31 May 1990, p.15) if the rejection of existing sources of economic advice is any guide.

In his speech to the National Agricultural and Resources Outlook Conference in February 1990, Michael Lempriere, president of the Australian Council of Wool Exporters, who commissioned the ACIL report, commented as follows:

> Although it may not have appeared so at the time, most of the present problems are self-inflicted — a combination of over confidence from previous successes, people believing their own hype when a more cautious approach was called for, a little greed, and, most important, failure to appreciate the extent and rapidity of supply responses. (Lempriere, 1990)

As the first significant challenge to the policies being followed by the AWC and WCA, this speech represented a significant turning point in the relationship between the government and the wool industry over the emerging problems of the RPS. In the following three months, the WCA and AWC were forced to revise upwards their estimate of the wool tax that would be required to finance AWC stockholdings from the 15 per cent that was claimed before the election in March, when government approvals on borrowings had to be negotiated, to 25 per cent at the time of its annual meeting in Roma in May. At no time did the AWC and WCA concede that the reserve price might be unsustainable, even though the rates of tax suggested had become so high that it must have then been obvious to the commercial wool trade, already aware of existing stocks and expected supplies, that the RPS was in serious difficulties.

Residual Powers of Government

The underlying problem with the legislative arrangements for setting the reserve price was that they required independence of the AWC from the WCA, which, however, does not exist given the strong allegiances of producer members of the board of AWC to farm organisations. In addition, non-producer members of the board of the AWC could also feel under some pressure from the WCA because of the manner in which selection procedures for other board members had been organised. In effect, the economic and institutional arrangements for the wool industry were neither the fish of market discipline nor the fowl of Westminster responsibility and accountability. The RPS diminishes the discipline of the market because it creates the illusion for woolgrowers that output can be expanded without the risk of price falls, whereas nothing can be further from the truth. It also means that wool users do not respond as much to lower prices by increasing consumption during market downturns.

Nevertheless, there were still important safeguards in the wool marketing legislation that were available to government. The current Wool Marketing Act contains an overriding provision (section 120) empowering the Minister to give directions in writing to the AWC concerning the performance of its functions and exercise of its powers 'because of the existence of exceptional circumstances'. In addition, the upper limit of the wool tax, previously set at 10 per cent, can be altered only by parliament. With the compliance of the Opposition, this allowed the government to push the wool industry in the direction of lowering the reserve price by placing an upper limit on the wool tax of 20 per cent rather than the 25 per cent that was finally requested by the WCA. Finally, and of even greater significance in recent developments, the Minister has to approve AWC borrowing in excess of half its net assets. Existing approvals allowed the AWC to purchase up to four million bales at the previous reserve price, which would have been insufficient to finance expected purchases if the reserve price had been maintained at 870 cents.

Chapter 4

The Economic Environment of the Wool Industry

THE year 1990 saw the fourth occasion since 1970 that the wool market had been supported in a major way. Previously stocks were not as high, nor did they rise as fast. During the recent debate supporters of maintaining the reserve price drew a specious comparison between present stocks and the even larger stocks accumulated in Australia during wartime. There is an immense difference between stocks that existed because of wartime disruption to demand and shipping (and which were cleared because of the pent-up post-war demand for wool) and present stocks, which will have to be sold under normal market conditions. The irrelevance of this comparison did not stop it being recirculated *ad nauseam* by industry leaders and journalists.

Although stocks were disposed of previously by the AWC, the current situation is very different from those of the past, for two essential reasons. First, there was a significant underestimate of the price responsiveness of supply following the boom in 1987 and 1988, when the reserve price was set at profitable levels for woolgrowers, especially given the slump in the grain industry. Like other previous episodes in the history of the Australian sheep and cattle industries, when livestock populations have expanded very rapidly in response to price changes, the response of output to prices was greatly magnified by an unusual run of above-average seasons.

Second, in the tradition of failed buffer stock schemes, the wool industry believed that the boom in 1987 and 1988 was a reflection not of fluctuations in the market but of permanent factors, especially the success of policies pursued by the wool industry in research, development and promotion. It should also be noted that the subsequent contraction in demand that occurred in the developed economies was largely caused by blending and substitution of other fibres for wool that had been induced by the earlier boom. This was compounded by the political difficulties of the USSR, China and Poland, which have also affected the demand for Australian wool.

Moreover, on previous occasions when stock accumulated, Australian output was falling or static. But wool production has increased by around a half in the last eight years, and a thumping 17 per cent in the last twelve months. The increase in wool production over the last year was larger than the output of any other exporting country except New Zealand, whose wool is used mainly for the manufacture of carpets. For wool with a diameter of less than 25 microns, which accounts for over 80 per cent of Australian wool, the increase in production over the eight-year period was roughly equivalent to the annual production of the USSR, the world's second largest producer.

The Nature of Wool Supply

The supply of wool is unresponsive to price changes in the short-run (less than a year) because of its long period of production and the integration of woolgrowing with other enterprises in the Australian agricultural system. Wool is a joint product with sheepmeat; and on grain-livestock farms, which account for around a half of Australian wool production, production of wool and sheepmeat is insensitive to prices because of the positive contribution of sheep to grain yields in crop rotations and the opportunity provided to spread the overhead costs of labour. In addition, many of the resources used in wool production are long-lived and will be used so long as variable costs are covered by receipts from wool and sheep trading. The least flexible resource in the short term, of course, is the sheep, which will be retained (pasture production permitting) so long as its expected value in wool production exceeds its salvage value as mutton or in the live sheep trade.

Nevertheless, as recent events amply demonstrate, wool production does respond significantly over time to higher prices through substitution within the sheep enterprise and between sheep and other enterprises. While it was impossible for the supply of wool to continue to increase at the same rate as in recent years, there was no compelling reason to expect a marked decline unless there were a substantial increase in the wool tax and/or reduction in the reserve price. This is mainly because a major determinant of wool production is rainfall, which was more than abundant in the pastoral areas of New South Wales and Queensland in the autumn and winter of 1990. Notwithstanding losses from floods, these important wool-producing areas will have a reserve of standing feed that could sustain the sheep population at high levels for a year or so.

Moreover, the disruption to the live sheep trade to Saudi Arabia, and latterly Iraq and Kuwait, together with changing expectations about the long-term prospects of the wool industry, have reduced dramatically the salvage value of sheep. Many producers are in the position where the sensible private decision would be to hang on for a while, whatever the long-term aggregate consequences. Favourable seasonal conditions, however, do not last for ever. It seems that a mutton mountain will eventually accompany the present wool mountain, whenever the downturn in seasonal conditions occurs. There is also the prospect of significant environmental damage in grazing areas.

The limited short-run responsiveness of the supply of wool is also related to the investment farmers require to change enterprises. Investment in sheep production is less lumpy than it is for grain and cattle. Even though prospects for grain and cattle have improved since the recent spectacular growth in wool output was initiated, the increases are not enough to have much immediate influence on the supply of wool. In fact, the recovery of grain prices appeared to have petered out following large harvests in the Northern hemisphere in 1990, even before the further disruption by recent political developments in the Middle East. There is also some uncertainty about the response of producers to increased wool taxes. Increased taxes on wool could be regarded by some producers as more like a compulsory loan than a permanent reduction in price.

For all these reasons, it was both reasonable and prudent to assume there would be no substantial change in wool production over the next couple of years, unless there were an immediate increase in the wool tax and/or reduction in the reserve price that substantially reduced the profitability of wool production. Even then, the actual outcome could be dominated by seasonal conditions and independent economic developments that occur in other industries. It is important to note that the management of the RPS also suffers from being dominated by a single commodity approach, reflecting the political and institutional arrangements for Australian agriculture, when the economic reality is that the agricultural production system is characterised by multi-enterprise farms.

Prospects for Demand

Assessment of prospects for demand was an important element in judgments about whether the reserve price should be lowered. The major economic feature of the demand for wool is the fact that wool is used in the manufacture of durable consumer goods. Consumption of apparel is sensitive to short-run changes in income because consumers hold stocks of clothing that are like capital items and yield their services over an extended (and variable) period. This is especially important for wool apparel, which is generally much more expensive than for other fibres.

There was nothing on the international horizon that gave cause for much optimism about prospects for demand for wool based on increasing incomes in consuming countries. On the contrary, the build-up in Australian wool stocks had occurred independently of a downturn in the textile cycle caused by lower incomes in major consuming countries. This is consistent with the hypothesis that the build-up was largely supply-driven, exacerbated by optimistic setting of the reserve price. The important factor on the demand side was not income but the blending and substitution of synthetics for wool that had increased significantly in response to the earlier high prices.

It was also common during the recent debate over the reserve price to attribute the increase in AWC stocks largely to a decline in exports to China following the events of Tiananmen Square in June 1989. But Chinese purchases of wool had started to decline well beforehand, from their unusual peak in 1987 and 1988. In fact, the reactions of the Chinese wool industry in the wool market can be explained partly by the interaction of price and exchange rate effects and not merely by political developments.

The most alarming prospect facing the Australian wool industry in 1989-1990 was sharply falling activity in the world wool textile industry in response to worsening economic conditions (particularly in the centrally-planned economies which have been important customers for Australian wool), with catastrophic consequences for the AWC. By March 1990, the AWC was, in effect, in a situation similar that of an over-indebted private company, whose views on prospective sales are not necessarily shared by its bankers.

Given that Australia's share of world trade in apparel wools is about two-thirds, the increase in output that had occurred in recent years was too high to be absorbed without reductions in prices, unless there were a spectacular increase in demand. By way of comparison, virgin wool consumption by the textile industry had increased by only around 11 per cent between 1984 and 1988, a period that included the recent boom in wool prices and the run-down of previously-acquired Australian stocks.

Effects of Exchange Rates and Financial Deregulation

The market indicator, or weighted average, reserve price was increased by over 70 per cent between the 1986-87 and 1988-89 seasons. This was way above the level consistent with the long-term trend in Australian wool prices. The objective of the RPS was changed, therefore, from its stated role of modestly reducing price risks for producers and processors to one that resembled an attempt to extract higher prices from wool users (ACIL, 1990). This increase followed significant changes in the management of the Australian economy which have implications for the RPS; in particular, floating the Australian dollar and financial deregulation.

The RPS was developed in the era of fixed exchange rates, when stabilisation of commodity prices was regarded as important to economic management in countries like Australia, where a substantial proportion of export income is derived from commodities like wool. The change to a regime of market-determined exchange rates had several consequences for the RPS. It is no longer possible to stabilise the price of wool to overseas users by setting the reserve price in Australian currency. Although purchasers of wool can cope with the risks of adverse changes in the exchange rate in various ways, the management of the RPS is now hostage to developments in exchange rates that are completely unrelated to wool. For example, the boom in wool prices in 1987 and 1988, at least as measured in Australian currency, can be interpreted as a lagged response in the demand for wool stimulated by the substitution of wool for synthetics induced by the sharp fall of the Australian exchange rate in 1985 and 1986 (Beare & Harris, 1989). Much of this fall has been reversed, increasing the price of wool in user currencies and encouraging more blending and substitution of fibres at the expense of wool. There was therefore no compelling reason to argue that the recent boom in wool prices indicated a permanent change in demand that justified a substantial increase in the reserve price, however seductive that argument seemed to the wool industry.

Some leaders of the wool industry now seem to be hoping for a fall in the Australian currency that will reduce the price of wool in user currencies. This position, which implies that the demand for wool is sensitive to price, is completely inconsistent with their opposition to lowering the reserve price on the grounds that it would have no effect on consumption. Arguments about the appropriate level of the Australian dollar should have absolutely nothing to do with the management of the RPS, which has to adjust to macroeconomic policy rather than *vice versa.* Floating the Australian dollar has introduced a new set of risks for the RPS that now have to be managed by the AWC. These risks strengthen the points made above about the inherent difficulties of forecasting wool prices. It is conceivable that well-trained and informed commodity economists could do a reasonable job of forecasting wool prices in a world of fixed exchange rates if they were kept independent of political pressures. But it is far-fetched to believe that anyone could make the reasonable three- to five-year forecasts of the Australian exchange rate that would be required to manage the RPS successfully.

Moreover, deregulation of the Australian financial system changed the rules of the game for the RPS and also affected the ways that risks can be managed by farmers. Monetary policies have generated high real interest rates in Australia in recent years. The increased cost of borrowing for the AWC should have been reflected in a lower reserve price, since costs of financing stocks will eventually have to be recovered from the market, or, most likely, extracted from woolgrowers through increases in the wool tax. There is a substantial opportunity cost for growers in funds tied up in stocks of wool, whether these stocks are financed by AWC borrowing or by growers through increases in the wool tax.

Financial deregulation also changed the allocation of credit to farmers from rationing on the basis of quantity to rationing by price. The paternalism of the RPS, with its wool tax and Market Support Fund, is inconsistent with the spirit of financial deregulation, since it stops farmers controlling their own flows of funds and forces them to hold part of their wealth as stocks of wool. The NFF's and the WCA's optimism about the level of wool tax that would have been necessary to maintain the reserve price was, in view of the stance they usually adopt in matters of public finance, a political somersault of Nadia Comenici proportions.

Chapter 5

The Rationale of Reserve Price Schemes

IN an unregulated market, the combination of fluctuating demand and inelastic supply that characterises the Australian wool industry would cause extreme price fluctuations unless private stockholding moderated those fluctuations through stabilising purchases and sales. Private stockholding is potentially destabilising, however, if stocks of wool or semi-manufactured products (tops, yarn or fabric) are adjusted in the same direction as the change in prices to protect merchants or processors from changes in the book value of their stocks and hence their liquidity and financial stability. It is implicit in the decision to introduce a buffer stock scheme that stockholding by private firms in the wool industry provides insufficient stabilising speculation or excessive destabilising speculation (or both).

The potentially damaging effects of destabilising speculation on demand was perhaps the most important reason for advocating intervention in the wool market (disregarding here the allegiance of farmers who support intervention for intervention's sake or who believe that Australia has exploitable market power in the world wool market). Paradoxically, it is arguable that the stock disposal policies that were followed by the AWC in 1986 and 1987 were akin to destabilising (public) speculation. This is because when the price to users had already fallen following the fall in the Australian dollar, more stocks were then placed on the market by the AWC. Once these stocks were exhausted in early 1988, there was then a very rapid increase in prices.

When disposing of its stocks in the past, the AWC has followed the practice of waiting until there is some (unspecified) margin of market prices over the reserve price, as measured in Australian currency. That is a prudent and understandable practice for a buffer stock authority which, first and foremost, seeks to protect the producers who have financed its operations. Nevertheless, the application of such a rule, if based on prices measured in Australian currency, could easily destabilise the price of wool to users. In addition, in view of the possible lags between changes in prices and changes in production, it could even happen that the incomes of Australian producers are also being destabilised in a world of fluctuating exchange rates by buffer stock operations, as recently practised by the AWC. This is more than just a theoretical possibility, and it requires further empirical investigation. This effect is additional to the destabilisation of woolgrowers' incomes referred to above, which has occurred due to the arbitrary operations of the Market Support Fund.

The demand for wool is also affected by substitution between wool and other fibres, and by fashion. The response of the Australian wool industry to substitution and fashion effects has been to participate in a substantial program of promotion by the IWS. This involves advertising to influence attitudes of consumers and retailers, and research and technical development to make wool more attractive to early-stage processors, clothing manufacturers and consumers. Not surprisingly, the IWS has been quick over the years to claim credit for increasing prices, but attributes the recent change of circumstances to factors beyond its control.

Effects of Australia's Market Share

The economic circumstances of wool differ from those of other Australian commodities in another important respect. The large share of the world market for apparel wool accounted for by Australia makes the price received by producers dependent upon Australian output. The fact that Australia is not a price taker on the world wool market raises the interesting theoretical possibility that national income could be improved by imposing a tax on wool exports. The case for export taxes was never overwhelming because, for one thing, compensating duties could have been imposed by importers in retaliation against export taxes, with some chance of jeopardising the considerable advantage that wool has in international trade where it suffers very few impediments.

Another effect of Australia's significant market share is the (usually unstated) belief that monopoly power can be exploited by Australia in setting the price for wool. To be successful in the long term, cartels require control over supply, which would be difficult to achieve even within Australia and impossible to enforce on other countries. Moreover, the development of synthetics and the contraction of wool's share in the textile industry has made it less likely that prices and revenue could be increased by withholding stocks from the market.

Nevertheless, the idea that Australia has the potential to exploit monopoly power on the world market has always been pervasive in the wool industry and re-emerged openly during the recent controversy in defence of the RPS, when price support and stabilisation objectives were confused by sections of the wool industry.

In an advertisement placed in the *The Australian Financial Review* on 29 May 1990, on the eve of the federal Cabinet's decision to lower the reserve price, the NSW Farmers' Association declaimed:

> In the 1960's, before the floor price scheme, collusion among certain wool buyers saw Australia ripped off as wool prices were squeezed unfairly. Since then, the floor price scheme has ensured a stable marketing environment for wool and higher export income for Australia.

These sentiments, expressed by the largest State organisation of woolgrowers, leave little doubt that some leaders of the wool industry believe that the RPS can have a price-raising as well as stabilising effect and that farmers' age-old suspicion of middlemen is still alive and well in the Australian wool industry.

Grower Support for the RPS

Woolgrowers support the RPS for two main reasons. The first relates to the advantages of stable prices for financial management; in particular, the securing of long-term investments in farm development and land purchase. This link between the price of wool and investment explains why the lowering of the reserve price was vigorously resisted; since the reserve price had been taken into account in borrowing decisions by woolgrowers, it was reflected in land and livestock prices.

Provided that the reserve price was set conservatively and could be maintained, there would not be much to quarrel with in this argument, at least when viewed from the standpoint of the individual farmer. A wider perspective would consider the costs and benefits of other approaches to financial management and consider the wisdom of focusing all producer decisions on a single estimate of wool prices when the future state of the wool market is in fact extremely uncertain.

Australian woolgrowers already face substantial production risks because of the vagaries of the climate and marketing risks for other commodities produced on multi-enterprise farms. It can even be argued that merely reducing the risks of fluctuations in wool prices through the RPS only serves to encourage woolgrowers to adopt compensating strategies in the overall management of risk, and leaves the aggregate outcome essentially unaltered.

The second reason for producer support for the RPS is the belief that private (stabilising) speculation is deficient in an unregulated market and that destabilising speculation is damaging to the demand for wool. Now that the RPS for wool has existed for 20 years, questions about the nature of private speculation are somewhat hypothetical, since the RPS has eliminated most private speculation as stockholding has been shifted from private to public hands. Even though the RPS has driven most specialist speculators from the wool market, wool processors are always able to vary the level of their working stocks by leading or lagging purchases according to their views on prospects in the wool market. Consequently, the AWC is not completely immune from counter-speculation if the private trade believes that the reserve price is not credible, as was almost certainly the case when there was so much indecision about the reserve price in April and May 1990.

Other Effects

Since buffer stock schemes operate by stabilising the price of wool through the purchase and sale of stocks, the quantity available for processing is inevitably destabilised. Fluctuating throughput increases costs for processors, which offsets the advantages to them that might be attributed to more stable prices. Although a lot of emphasis in debates over the RPS has been placed on the alleged advantages of more stable prices to users, this remains an unresolved empirical question, about which it is extremely difficult to collect evidence that can be evaluated in a satisfactory way.

Leaders of the wool industry have always placed great store on testimonials received from processors in favour of the RPS. These were again well in evidence in the recent controversy over the reserve price. This verbal support from some processors cannot be regarded as anywhere near as reliable as their actions: they should be judged on what they do, not what they say. In any case, the opinions, and actions, of those in the textile industry who are not using much wool would be of far greater interest in deciding the issue.

The proposition that there is a favourable relationship between the stability of wool prices and the demand for wool was not generally supported by the most thorough theoretical investigation of the idea. Its conclusions were summarised as follows:

> The analysis presented above centres on the observation that, whereas the price mechanism redistributes risk between buyers and sellers, price stabilisation through buffer stocks does not permit such transfers. If, as would seem to be the case for wool, fluctuations in final demand or exchange rates are the major source of instability, the long-run effect of stabilising prices is to increase the risk faced by wool users and to decrease that faced by wool growers, relative to a situation where prices move freely. (Quiggin, 1983:39)

In addition, in recent years there has been considerable development of early-stage processing of wool in Australia in response to market developments. Given all the official and other rhetoric surrounding 'value adding' from greater domestic processing of Australian commodities, it would be ironic if this were nipped in the bud for the Australian wool industry by price policies that both increase the price of wool and restrict its availability. Of course, talk about encouragement of more wool processing in Australia is occasionally a thinly-disguised demand for further protection, which ought to be regarded as more value-subtracting than value-adding.

Another effect of the RPS is to increase (temporarily) prices received by other wool producing countries. As a rough guide to this international redistribution of income, New Zealand, Argentina, Uruguay and South Africa benefit by about $A25 million for every 1 per cent increase in the world price caused by the RPS. These countries will suffer lower prices when stocks are eventually sold and now have to adjust to the lowering of the Australian price.

The RPS has placed the Australian wool industry in a similar position to the US grain industry in the 1970s and 1980s, when unrealistic guaranteed prices were set in response to over-optimistic projections of long-term demand. When these expectations were not fulfilled, stocks accumulated and the price had to be lowered to dispose of stocks, greatly disrupting the world grain trade. Like all analogies, the comparison is incomplete. In the case of US grains, most of the costs fell on US taxpayers and producers in other countries. In the Australian case, the burden of mismanagement falls on Australian producers. Nevertheless, if US agricultural officials were better informed about wool, they would be wryly amused by the predicament of the Australian wool industry in view of all the criticism of their agricultural policies delivered by Australian spokesmen in recent years.

The wool industry also put itself in a situation similar to countries operating under fixed exchange rates that cannot be defended because of mounting external surpluses or deficits. In that case, economic forces invariably prevail, even though financial authorities deny the possibility and rail against the activities of speculators. Just as exchange rates have to be changed substantially if there is to be any effect on speculation and on the underlying cause of the economic imbalance that makes it inevitable, adjustment of the reserve price has to be substantial and well-timed once it is realised that it can no longer be maintained. The way events unfolded in the wool industry could not have been more different from this orderly state of affairs.

Chapter 6

Setting the Reserve Price: The 1990 Confrontation

THE gravity of the situation confronting the wool industry became obvious as the 1989-90 season progressed. With the unwillingness of the AWC and WCA to countenance lowering the reserve price, it was inevitable that there would be political intervention to correct the imbalance in the wool market. The conflicting positions of the wool industry and the government were only partly based on different judgments about the effectiveness of various combinations of wool taxes, borrowing limits and reserve prices in bringing about an adjustment of production and consumption of wool to reduce the costs of stockholding by the AWC, which threatened the long-term solvency of the RPS.

Somewhat paradoxically, given earlier objectives of making the AWC more commercial in its outlook, there was really very little incentive for the AWC, which was under so much pressure from the WCA, to change its policy once the government's position became clear. In the event, the industry's response was driven far more by politics than by considered judgments of the financial or commercial effects of various strategies. This is indicated by the fact that in his later speech introducing amendments to the Wool Marketing Act, Mr Kerin noted that the wool industry had reached its conclusions 'despite the presentations of AWC professionals'.

It is important to recognise that the cost of setting the reserve price too high was incurred when the decision was taken. What was being argued about between the government and WCA was whether continuation of existing policies would involve even greater long-term costs to the wool industry and also the distribution of those costs amongst woolgrowers and others in the wool trade who had made their decisions based on a reserve price of 870 cents.

Government Policy and the ABARE Study

The basis of the policy that the government promoted is contained in a document setting out the economic consequences of different options produced by the Australian Bureau of Agricultural and Resource Economics (ABARE, 1990) and in the speech given by Minister Kerin at the WCA annual meeting in Roma in May. A strong theme that runs through the Minister's speech is that, because the wool marketing arrangements depend upon legislation, particularly the power to raise the wool tax and the controls over borrowing by the AWC, the Minister is ultimately responsible for the outcome and could not stand aside if he considered that the policies favoured by the WCA, with the support of the AWC, would lead the wool industry and woolgrowers to financial ruin. His concerns were stated as follows:

> If we can't take a decision to change the price this year, with almost 3m bales, what chance would we have **next** year, faced with the possibility say, of 5m bales in stock? By then we would be in too deep. We would have no choice but to hold the MRP, and pay whatever tax is necessary and try to gain maximum borrowings. We would be gambling, and the ultimate bankruptcy of an entire generation of people in and associated with the Australian wool industry would be a distinct possibility. (Kerin, 1990:8)

The ABARE paper compares the financial consequences of combinations of reserve price and wool taxes under a range of supply, demand, borrowing limits, interest and exchange rate assumptions. It is a simple but effective approach using spread sheet methods of calculation to test the sensitivity of the net present value of industry returns to changes in economic variables. The ABARE approach is based on simulation of a range of assumptions and answers 'what if' questions. It does not, and could not, purport to estimate what the true values of the important economic parameters might be in the existing situation in the wool market. In particular, it does not address the assumptions on which the RPS is based.

Despite these qualifications, the results of the ABARE calculations strongly supported the strategy of lowering the reserve price to 700 cents with a wool tax of 20 per cent, rather than the AWC/WCA strategy of maintaining the reserve price at 870 cents with the wool tax set at 25 per cent in 1990-91 and maintained at that level in subsequent years. In fact, ABARE's calculations suggested that much higher rates of tax would be needed if AWC borrowing were restricted to $2.5 billion. With unconstrained borrowing, a reserve of 870 cents and a constant wool tax of 25 per cent, stocks would continue to increase to

6-8 million bales after five years with a negative balance of $1-3 billion in the Market Support Fund. (The ranges reflect different rates of adjustment of production to the lower net prices received by woolgrowers.)

An oft-repeated argument for the strategy of no change preferred by the AWC and WCA was that lowering the reserve price would harm private holders of stocks of wool and semi-manufactures by reducing the value of the stocks. This was based at times on the fallacy that the value of assets depends upon their purchase price rather than on their value in the market. Nevertheless, manufacturers of wool products do have a legitimate concern if they maintain a wool stockpile for its convenience yield, but competing manufacturers speculating that the RPS cannot be maintained do not. Those competing manufacturers are able to sell wool or semi-manufactures cheaper than other manufactures if wool is eventually sold from the stockpile reducing its market price. In this sense, supporters of the AWC in the wool textile industry were simply arguing that the confidence that they had previously shown in the strength of the AWC's position had proved costly to them. Obviously, the losses that are incurred by this group ultimately have to be compared with the costs of maintaining the stockpile.

In the ABARE simulations, the policy of lowering the reserve price is superior to strategies that rely exclusively on increasing the wool levy essentially because lower prices act on both sides of the market, discouraging production and encouraging consumption. Moreover, maintenance of the reserve price would continue to assist wool producers in other countries, as well as competing fibres. Not only do the mathematics of discounting favour quick resolution of the problem by reducing production, increasing consumption and reducing interest and other costs of storage sooner rather than later; it is also more equitable since costs are borne by the existing population of woolgrowers. Further delays would have left specialist woolgrowers in danger of bearing a substantial financial burden as others left the industry.

The key determinants of the results of the simulations undertaken using the ABARE model are the assumed elasticities of supply and demand and assumptions about prospective demand. Interested and disinterested observers will have their own views on these key parameters. On balance, the present writer believes that the ABARE simulations are fair to the industry case. ABARE may even have underestimated the effects on production of the lower returns to producers from increased taxes and lower reserve prices, but they are reasonably optimistic about demand. In addition, by concentrating on wool and not allowing for increased production of products such as grains and beef, ABARE has underestimated potential gains from lowering the reserve price. The inescapable conclusion from the ABARE paper is that the financial risks for both the AWC and woolgrowers of an unchanged reserve price, and the higher wool taxes that it would have implied, would have been far greater with no change than with the policy eventually forced upon the wool industry.

Industry Reaction

The ABARE paper was released in the week preceding the annual meeting of the WCA. Such meetings are not really suitable for considering subtle economic arguments, since delegates are already locked into established positions. Economists may argue over the extent of the responsiveness of supply and demand to prices, and invest a lot of effort in economic measurement and in examining the sensitivity of models to alternative views; but such uncertainties seem to have made no impression on the organised wool industry. The debate at Roma quickly abandoned the search for considered and quantitative judgments about the financial and commercial consequences of various actions, and concerned itself with 'industry control' and the rejection of what was seen as unjustified interference by government in the affairs of the wool industry.

However, it is possible to interpret the reactions of the AWC and the WCA in terms of more standard economic concepts. Above all, their position depends on assertions by the wool industry's 'international marketing experts', 'that there is no evidence that a drop in the floor price would increase the demand for wool' and 'once cut, a new "floor" price would be a speculator's dream and a woolgrower's nightmare' (AWC News Service, 21 May 1990). In other words, stability of prices is everything and price levels are irrelevant to consumption. All the required adjustment therefore has to come from the supply side through increasing the wool tax, until such time as the wool textile industry is also convinced that the reserve price can be maintained. Needless to say, it is difficult to find any economist who can endorse this application of standard economic concepts, whether as a matter of doctrine or of pragmatic reality.

The argument goes to the heart of the theory of price formation in markets. Economists are more inclined to believe that 'market confidence' is ephemeral and that purchasers of wool make rational calculations of commercial opportunities to process and manufacture end-products that are sold to consumers. In these calculations, available supplies of wool, the price of wool in relation to synthetics, consumer incomes and fashion preferences are much more important than 'confidence'. In the world of producer control of the reserve price, a different paradigm exists. Markets can be talked up (or down), and commercial operators in the wool market have to accept the price that is set for them.

Marketing Initiatives

The wool industry also put great store on the potential for new marketing initiatives to influence the demand for wool. As pointed out by Lloyd (1990), 'if rapid demand increases could be achieved by these means, it would be scandalous if they had been left unused in the past'. These marketing initiatives included concessional credit to purchasers to encourage wool consumption: which is, in fact, a price-related measure, since lower interest costs would effectively lower the price to selected users.

The present writer, as an employee of the IWS, was involved in an investigation of an almost identical proposal in 1971 that then attracted influential support from within the Australian wool industry and considerable disdain from the Treasury. There was obvious enthusiasm from some sections of the wool trade for access to concessional credit, even though its overall benefits could not be demonstrated. As it turned out, if the proposal had been implemented at the time, recipients of concessional credit, who took stocks off the hands of the (then) Australian Wool Commission, would have made even greater windfall profits when the wool market recovered in 1972 and 1973. This is a another example of the problems always faced by the RPS, because it has no clear policy for the disposal of stocks once market prices rise above the floor.

Selective programs of expanded wool promotion were also advocated by the AWC as an alternative to lowering the price of wool, especially in the US for end-uses like trousers where it was claimed that the proportion of wool in blends could be increased substantially through special incentives. It would not be too churlish to suggest that some enthusiasts for this marketing approach, ever ready to turn defence into attack, regard the opportunity that is presented by the unplanned accumulation of the AWC stockpile as a chance to go down the road favoured by some sections of the wool industry in the 1970s, when an acquisition scheme was proposed for Australian wool

(AWC, 1973). This possibility seems to have been recognised by the Minister. In his Second Reading speech on the Wool Marketing Amendment Bill 1990, which provided for guarantees by the Commonwealth for AWC borrowings (a significant concession that was made after the lowering of the reserve price), Mr Kerin stated:

> I also have concerns that the proposal for the AWC to hold a substantial level of stocks, as part of their marketing strategy, departs from the original intent of the scheme. The new proposal has connotations of an acquisition policy. A policy, I would add, rejected by the industry in the 1970's. Such major changes away from the original policy or legislative intent must be subject to open review and debate before being implemented.

It is arguable whether it is strictly accurate to say that acquisition was rejected by the 'industry'. Of course, Mr Kerin's observation could also be made about the RPS. It was rejected in an industry vote in 1965, most decisively in New South Wales, where the organised wool industry is now most vehement in support for the RPS. Although the later argument over acquisition did not reach the intensity of the earlier debate over the RPS, it is probably truer to say that the proposals by the AWC for acquisition in the 1970s — 'integrated marketing' in the jargon of the day — foundered on the lack of bureaucratic and political support rather than rejection by the wool industry.

The essential problem with these recently-proposed marketing initiatives, as would also be the case with a fully-fledged acquisition scheme, is that wool is made available to some users on preferred terms to the disadvantage of their competitors. This changes drastically the rules of the game in the commercial wool trade. In effect, the widespread use of such interventionist marketing practices by the AWC would put the Australian wool industry in the position of competing with its own customers. The AWC would then well and truly be in the business of 'picking winners' in the extremely diverse and internationally footloose wool textile industry.

There is an almost child-like enthusiasm for these marketing initiatives within some sections of the wool industry. At the bitter end of the protracted negotiations over the reserve price, the AWC presented the Minister with a 'Marketing and Floor Price Proposal', which contained minimal detailed economic analysis so that its rejection was almost inevitable. According to John Hyde (1990), among the more debatable points in that document was the claim that these AWC initiatives would increase wool sales by more in the next six years than has occurred in the last 40 years. The proposal also implied that the initiatives would only work at the existing reserve price, despite the fact that they are mainly targeted at price-sensitive sectors of the US market.

The tone of this document, and other dealings over the whole episode, suggest that the AWC and its public relations apparatus have extrapolated traditional woolgrower disdain for the Canberra bureaucracy to the point where it is believed that public servants are not merely 'economic purists' but can no longer handle simple concepts that are mainly based on common sense and arithmetic. Indeed, the recent controversy over the reserve price raised some important issues over the appropriate role of public relations activity in dealings between government and its own instruments. It is becoming increasingly difficult for the public to be reasonably informed on economic questions, which of their nature are almost always matters of degree rather than of kind, because point-scoring and exaggeration have become the accepted currency of public debate.

The Role of Wool Promotion

It may be the case that expanded wool promotion is justified under certain conditions, but that decision must be considered separately from arguments about the RPS. Lewis (1979, 1981) pointed out very forcefully the costs and conflicts that emerge if long-term programs and strategies for promotion are tailored to short-term needs based on the size and quality composition of the wool stockpile. He encapsulated some of the problems experienced in the 1970s as follows:

> IWS experience with these special measures to provide support for stronger wools would tend to cast doubt on the effectiveness of promotion as an instrument for offsetting or countering short term market disturbances. Certainly the pay-off period for most of the product development projects, undertaken to provide relief for stronger wools, was too long for their outcome to have relevance for that purpose. (1979:132)
>
> It may seem logical enough, *prima facie*, that wool promotion should be thus co-ordinated with price stabilisation programmes. It is difficult to know whether wools are 'neglected' because they have been overpriced by the price stabilisation

> authority, in which case an adjustment in the reserve price *bareme* or schedule might well be a better means of correcting an imbalance in stock holdings. Even if this is not so, there is something to be said for the view that the reserve price authority should be prepared to hold stocks until a period of more buoyant demand and should not expect promotion to bring about a more or less instant transformation of demand relationships as and when required. (1979:134)

> The latter incident illustrates the parochialism of a few IWS branches which are inclined to put the support of domestic textile industries ahead of the wider objectives of their woolgrower sponsors. In one case the French branch paid for the exclusive services of a design consultant to aid a French manufacturer to withstand Italian competition. (1981:13)

> One of the greatest pitfalls in wool promotion is to disburse advertising funds as a form of economic rent, not serving to change the actions of the recipients. In working for many years chiefly with the two giant textile manufacturers, Burlingtons and J. P. Stevens and withholding support from smaller but potentially more responsive firms, I believe the U.S. branch of IWS fell into this error. The two huge multi-fibre processors were glad to take IWS funds to help them do precisely what they would have done anyway. (1981:15)

These criticisms by Lewis, which were certainly not appreciated by the wool industry at the time either for their outspokenness or for their accuracy, apply to many of the suggestions contained in the 'Marketing and Floor Price Proposal' advanced by the AWC as an alternative to lowering the reserve price.

Nevertheless, there are some good economic arguments for the overall strategy of wool promotion followed by the IWS and also some well-researched quantitative studies that support its effectiveness. Unfortunately, the case for wool promotion has often been undermined by the large number of bad economic arguments and empirical 'justifications' advanced by the Australian wool industry in its supportwhich on closer examination appear unsustainable. We have already noted that public relations can never be an effective substitute for rigorous economic analysis.

There have even been some indications that research and development may also be redirected to accommodate these marketing initiatives by the AWC (ABC, 'Country Hour', 7 August 1990). However much this is dressed up as being 'commercial' or 'market-driven', it remains a most ad hoc, and potentially damaging, way of setting research priorities: which, in fact, require a much more subtle and long-term analysis than can be generated by these knee-jerk reactions to current difficulties. It is probably not surprising, however, that the recent difficulties of the wool industry brought forth this enthusiasm for these poorly-defined marketing initiatives and other solutions from an industry prepared to grasp at any straw to defend the reserve price. In this case, political necessity was clearly the mother of intervention.

Among other solutions suggested were: delivery quotas to restrict supply; definition of a category of specialist woolgrowers to be given preferred access to the market; and — perhaps the most bizarre — purchase and slaughter of sheep by the AWC to reduce the supply of wool. All of these proposals have their own problems and, most important, none of them could have been implemented quickly enough to have had much effect. Moreover, how the proposals would be administered or financed was not spelt out by their supporters.

Chapter 7

Conclusions

THE suggestion that a buffer stock scheme could be successfully managed with exclusive producer control of the reserve price would always be regarded as extremely fanciful. Sooner or later, enthusiasm would run ahead of reason; the Australian wool industry actually insisted that the price could only move upwards in nominal local currency, a policy that was very difficult to maintain following the floating of the Australian dollar. It must surely be irrational to insist that the nominal reserve price is inviolate when producer prices can be drastically lowered by increasing the wool tax, when user prices can fluctuate with the exchange rate and when the cost of storage is reducing the value of stocks by almost 2 per cent a month.

The Australian wool industry was unable to change its policies. The government, which had residual powers even in the permissive arrangements that had existed for setting the reserve price, had to decide whether there were overriding issues of wider interest to the community or sufficient danger to the long-term health of an important industry to justify intervention. Even the analysis of the AWC and WCA suggested that the reserve price could not be sustained without large increases in the wool tax: which would itself have devastating financial effects on many woolgrowers. The marketing strategies advanced by the AWC could only be taken on trust and were advanced in an atmosphere of crisis, without the time for careful consideration of their long-term effects on the commercial wool trade. The government has followed the prudent policy of reducing the risks facing the wool industry at the previous reserve price.

Recent events amount to more than a little bit of bad luck brought about by unusually favourable seasons, or the unexpected withdrawal of major purchasers like China from the wool market. They have more to do with the initial unwillingness of the AWC, IWS and industry leaders to acknowledge the effects that a high reserve price could have on production and consumption and their obstinacy in refusing to act once the effects of their earlier actions became clear.

The resentment felt by the leaders of the wool industry at what it sees as government interference and the unwelcome carping of economists perhaps stems from a confusion between the circumstances of the recent dispute, which should have been a technical argument about supply, demand and the role of prices in the market, and the quite separate status of the wool industry as an efficient industry in receipt of minuscule government assistance. Industry leaders, against the background of the relative success of the RPS in the past, confused this expression of economic independence of the wool industry from government with a generalised demand for immunity from government action to correct their own mistakes. But the wool industry has the right to expect that the government will be as courageous in its much-vaunted program of microeconomic reform when it encounters opposition from special interests closer to its own base of political support, whose current privileges come at the expense of industries like wool.

Following the eventual decision to lower the reserve price, Minister Kerin announced that there would be an official inquiry into wool pricing and marketing. The terms of reference of the review, to be headed by Sir William Vines, a former chairman of the Australian Wool Commission and managing director of the IWS, were set out in a Media Release from the Minister for Primary Industries and Energy on 23 July 1990 as follows:

> Against the background of the current wool market situation, outlook and likely changes in the wool textile industries, the Committee is to inquire into and make recommendations on ways to improve the efficiency and effectiveness of:
>
> a) the procedures and mechanisms for determining the minimum reserve price for wool;
>
> b) the role of stockholding in price stabilisation;
>
> c) arrangements for processing wool in Australia;
>
> d) the role of the International Wool Secretariat and the relationship between it and the Australian Wool Corporation.

Although these terms of reference give the wool industry an opportunity to consider its policies and plan for the future free from the overheated passions of the recent past, the Minister has also stated that 'it [the inquiry] is not about a fundamental re-examination of the

Minimum Reserve Price for wool'. While it is true that the central matters for consideration by this inquiry should be matters of policy and its implementation rather than technical economic issues (more than enough is already known about the economics of the Australian wool industry and the fine points of buffer stock schemes), it is hard to see how a searching investigation of the contemporary relevance of the RPS can be avoided. The background to the inquiry, and its terms of reference, will lead inexorably in that direction. It would seem, however, that arrangements to do with wool processing within Australia are peripheral to the main points at issue.

Several recent investigations of other Australian agricultural industries, notably in the wheat industry, have demonstrated that the greater transparency of industry and government policies that is encouraged by open inquiry processes is advantageous in itself. If recent events have demonstrated anything, it is that the wool industry should no longer be able to shelter behind its self-satisfied appreciation of its own performance.

If, as now seems politically inevitable, the RPS is to continue in some form, perhaps the most desirable outcome that should come from this current inquiry would be a recognition that the WCA has to take a back seat in its management. Furthermore, the inquiry should be very sceptical about implicit AWC proposals for greater intervention in the wool market, which are tantamount to the introduction of an acquisition scheme by stealth.

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