Strategic Asset Management

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MAKING THE HEADLINES IN 2001

A chance to review a few of the events that made headlines this year— and consider some of the messages

Whether on the ground or in the sky, aeroplanes certainly made the front page this year. There are many lessons to be learnt from the Ansett collapse, and the terrorist attacks on the World Trade Building will have repercussions in building design amongst other things; but in this end of year issue, I would like to look at two items that go to the heart of the 'eternal vigilance' that all asset managers need to exercise.

We lead off with the *Australian Financial Review's* report of **the demise of the Japanese construction industry**. Corruption? Yes, but don't be too quick to put this in the "it couldn't happen here" basket. Unless ordinary individuals expect that ALL of our asset decisions from acquisition, to maintenance, to operations, to disposal, will be carried out with efficiency, effectiveness and care for the environment and social equity – and react vigorously as soon as there are any signs that this is *not* happening – we could go the way of Japan.

Bear this in mind when you read the account of the **Commonwealth Department of Finance's disposal of property assets** as reported in the *Canberra Times*. There are some uncanny parallels in bureaucratic intransigence and unthinking incompetence. I am not arguing that corruption was present in that decision, but the possibility of corruption is always present if we do not vigorously defend sound asset management principles.

My third choice is from *The Examiner*, in Tasmania, and the report **of the coronial inquiry into an accident at Cradle Mountain** earlier this year, which resulted in the loss of life of 4 people. My reason for including this is NOT to imply incompetence, nor corruption, but rather to illustrate the very difficult trade-offs that need to be made in the practice of sound asset management.

Researched and written by Dr Penny Burns, AMQ International.
Published fortnightly. Subscription, Comment, or Inquiries to

AMQ Intenational
PO Box 75 Salisbury South Australia
Tel 618 8258 4342 Fax 618 8281 5795
Email: sam@amqi.com Website: www.amqi.com

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JAPAN'S CONSTRUCTION STATE LIES IN RUINS

The World's second-largest economy faces acute political and social turmoil- why?

Terrorism is not the only threat to the global system. No terrorist attack was required to bring Japan, the world's second-largest economy, to the brink of collapse.

Chronic Deflation

Japan has long been the "sick man" of global capitalism, the only industrial country since the 1930s to experience chronic deflation, its land and stock values down to about one third of their 1989 peak levels and still sliding. The Nikkei, already enfeebled when the Koizami government came to power in April, shed a full 30% of its value before September 11 and more thereafter, breaching the 10,000 barrier. Industrial production and commodity prices are falling steadily, while recession-induced unemployment, bankruptcies and suicides are mounting.

Banking System on Brink of Collapse

The banking system is riddled with "bad" debts, estimated at between ¥ 43 trillion and ¥ 150 trillion (between $750 billion and $2.5 trillion). Prime Minister Junichiro Koisumi insists magisterially but vaguely that he will solve the problem "in two to three years". However his estimate of the sum involved ¥13 trillion, is well below the figure given by his own finance ministry (¥43.4 trillion), which in turn is far below independent estimates. Simply to write off the debts would constitute a "shock therapy" that would deepen the recession and bring on a wave of bankruptcies and a tsunami of unemployment, adding between 500,000 and 1.5 million people – or in the view of some foreign experts maybe three to four million – to the three and a half million already unemployed. Even nationalisation has begun to be debated.

Bad Debts—30% GDP to clean up

Private sector estimates of what would be required to clean up the bad loan problem are bleak. One estimate is that up to 30% of GDP would be necessary, 20 per cent to be handed over to the banks to replenish their capital and wipe out the red ink and 10 per cent to provide a safety net for

By Gavan McCormack, Professor in the ANU's Institute of Advanced Studies. His 1996 book The Emptiness of Japanese Affluence has been published in Japanese, Korean, and Chinese translation, and a revised second edition was recently issued by M E Sharpe in New York.

the victims of bankruptcies and unemployment. Paul Krugman recently called for the use of about 10 per cent of GDP. Whether 10 per cent or 30 per cent of GDP, however, the sums involved are vast, and many times greater than anything the government has contemplated.

Public Sector Debt is Worse

Even more serious an intractable than private sector debt is the burden of debt on the public sector. Japan's public debt, ranked No. 1 in the OECD, soared in the 1990s from 58% of GDP to (an anticipated) 140% in 2001, and is on track to reach 200% by 2005. If the deficits of public corporations are included, it stands at more than ¥ 800 trillion (16 years of tax revenues), and will rise to ¥ 1,230 trillion by fiscal 2010. It now constitutes almost one fifth of total global debt. Merely to stabilise it by the year 2005 would require either a boost in revenue or a cut in expenditure by more than ¥ 50 trillion, about one tenth of GDP.

Deeper in Debt than Anywhere Else in Modern History

Asher and Dugger show Japan to be in a worse position in terms of public debt than Britain in 1947, Italy in 1991 or even Weimar Germany in 1921; in short, to be deeper into a debt crisis than anywhere else in modern history. The IMF has been called in, Japan ignominiously following Korea, Indonesia and Thailand.

On Brink of Bankruptcy

Japan's general and specialist journals have for years been declaring the country bankrupt or on the brink of bankruptcy. According to Takemura Masayoshi, minister of finance in the mid-1990s, only I the extraordinary circumstances of war has Japan ever experienced such desperate financial straits: "The country is ruined"…

Public Works Operated to Benefit the Few

How has once mighty Japan so fallen? The short answer is by its unique political and economic system centred on public works. The Japanese economy is dominated not by its internationally know manufacturers but by the "Iron Triangle" of politicians and bureaucrats and the finance and construction industry. The system is especially difficult to reform because it operates in an irresponsible and opaque way to privilege bureaucrats empowered to channel the national savings into debt-encrusted public bodies, in which many of them look forward to lucrative, post-retirement sinecures. Whether needed or not, politicians must deliver public works to their electorates, and in return they expect political funds and votes.

'Pump-Priming' the road to disaster

In the early post-war decades, the need for social infrastructure was obvious, and growth was so rapid that public investment programs were quickly paid off. From the first oil shock of 1973, however, high (or "miraculous") rates slowed and the developmental state relied increasingly on debt-supported, pump-priming, public works packages. …

"Too much of a Good Thing"

Japan's public works sector grew to be three times that of Britain, the US or Germany. It employs 7 million people, spending each year between ¥40 trillion and ¥50 trillion, about two to three times that of other industrial countries. Japan came to have more dams and more roads per unit of land than the continental US, half its coastline and most of its rivers lined with concrete, 90% of tidal wetlands drained, its groundwater drastically depleted, its bio-diversity threatened. Such works soaked up unemployment, fattening farmers as well as bureaucrats, but slowly the collusive structures at the system's core corrupted both politics and society. …

The "Construction State"

Under the "Keynesian conservative" mainstream of the ruling Liberal Democratic Party, the "construction state" spread its web of power and interest throughout the country, displacing politics in the strict sense while achieving legitimacy because it served as an engine of growth. The landscape of regional Japan is littered with disastrous projects in regional industrial development from the 1970s and disastrous "resort archipelago" projects from the 1980s. A typical project of the latter is Sea Gaia's "Ocean Dome", the model resort in Miyazaki prefecture with its covered beach and artificial waves, 750-room hotel and 5,000-person conference hall. It collapsed in February leaving a debt of ¥ 276 billion. Countless towns and villages throughout Japan now ruefully face financial crisis because of the legacy of the collapsing "construction state" projects in regional develop or resorts. And long after the collapsed assets have been sold off by liquidators the financial burden will weigh on local governments.

Public Works Bankrupted the Country

"the 'future eaters'"

Those decades of growth, unstainable and "future eating" as they how have to be seen, were characterised by corruption and fiscal irresponsibility, unnecessary and often ecologically damaging public works and rising levels of public sector debt. In effect, public works infrastructure was replaced by "extrastructure", works undertaken for their own sake, which eventually bankrupted the country and left a bleak inheritance for future generations.■

Canberra Times August 2 2001

AUDITOR BLASTS PROPERTY SALES

"The Department of Finance and Administration is openly defying the Auditor-General over a damning audit of its $983 million sale of 56 government properties.

Question:
Granted the Department can choose to move out of the property managing business—but does it have the right to throw away community dollars in doing so?

The audit has blasted the department's handling of the Commonwealth Estate Property Sales Program. These ***include the sale and lease-back of the Australian Geological Survey Organisation building which, far from saving money, could cost the taxpayer a loss of $95 million at present value over 20 years.***

The department had also spent $20.6 million on 'sales advisers', legal advisers, marketing and other consultants to April this year, according to the Australian National Audit Office report tabled yesterday. …

The devastating audit report comes after the information technology outsourcing scandal and the long-running fraud case in the ACT Supreme Court over the fire sale by DOFA of former Department of Administrative Services businesses.

The auditors criticised DOFA's management of its contracts with external consultants saying some had not been chosen by competitive tender.

It had set an unreasonably high 'hurdle' rate which favoured the forced sale of properties. Some had been sold below market value while some sale and lease-back arrangements could result in financial losses for the Commonwealth. The auditors said the AGSO building could have sold for an extra $5.6 million if it had gone to the preferred tenderer.

Hurdle Rates
[The 'hurdle' rate was set at 15%, which the auditors said was 'unrealistically high'. The auditors were being exceedingly restrained! See discussion on hurdle rates in SAM 55 and SAM 56]

Both it and the R.G. Casey Building might reach a break-even point 11 years after the sale, and Discovery House after eight years. ***After this point, the Commonwealth could be paying far more than it could have gained from investment of the sale proceeds at the Commonwealth Treasury Bond rate.***

[Ed; Note that this assessment by the audit office did not even take into account a 38% rent rise being requested by the new owners at the time of audit]

The department said its role was to implement government policy and it was not charged with protecting the 'overall' interest of the Commonwealth.

Question:
What is the role of the Commonwealth Department of Finance
And is it the role of honest bureaucrats to at least anticipate, analyse and mitigate the outcomes?
What is the role of asset managers to analyse the consequences of these actions?

It has refused to implement any of the seven recommendations made by the Australian National Audit Office, saying its analysis was flawed in the first place. But the audit office said, "ANAO considers that... Finance is the only agency in a position to ensure that property divestment is consistent with the Commonwealth Property Principles and to make an informed judgement as to whether a property sales and lease-back transaction represents efficient and effective use of Commonwealth resources at the time of the transaction."

As well as reviewing its management of contracts with consultants, the report said DOFA should review its arrangements for tender evaluation, assessment of value-for-money and the 'hurdle' rate of return to be applied in the decision to hold or sell property.

The Opposition spokesman for finance, Lindsay Tanner, said the report exposed extraordinary financial incompetence on the part of the Government, which had sold assets to make short-term financial improvements at enormous cost to the taxpayer in the long run.

"If the Department of Finance and Administration is not there to protect the overall financial interests of the Commonwealth, who is? And what is DOFA's job?"

Question:
The Victorian Liberal Government lost an election partly because it undermined the role of the Auditor General; what is the value of an independent watch-dog, if its recommendations can be blithely ignored?

The Prime Minister, John Howard, denied knowledge of the report when questioned at a National Press Club lunch yesterday. But the Minister for Finance, John Fahey, has sprung to his department's defence, saying the program had been successful. Mr Fahey attacked the auditor's analysis and defended the sales and lease-backs which, he said, on proper analysis, represented value for money and had freed up capital for investment in core government functions for the greater benefit of the Australian community.

(The National Audit Office's report is on the internet at www.anao.gov.au/)

The Examiner, October 27, 2001

Sealing of Road Rejected

This is an exercise in multiple trade-offs! ***What would you do?*** *What extra information would you need to make your decision?*

"Bitumen change not practical, coroners court told.

Any plan to upgrade Cradle Mountain's Dove Lake Road from gravel to bitumen would cost $1 million a kilometre, the Coroner's Court in Burnie was told yesterday.

Infrastructure, Energy and Resources Department asset management branch manager, Peter Todd, told the court that ***sealing the road would also increase vehicle speeds on the road and have an impact on wildlife within the World Heritage area.***

Mr Todd gave the details in evidence on the second day of the coronial inquest into the fatal tourist bus accident at Cradle Mountain on February 18 this year.

The night accident on a narrow section of Dove Lake Rd claimed the lives of four people when the Mazda 19-seat minibus slide 33m down a steep embankment.

Mr Todd said the State Government had advised the department last year to draw up a priority list for a possible "once off" infrastructure fund. That list included $2 million of work on the road at Cradle Mountain which is now expected to be held over the next two summers.

Mr Todd said it had been the first time since 1992 that the road had been on any capital works programme. He told the inquest that the State Government had a contract with Civil Construction Corporation on the road regarding maintenance.

"Just before the accident the road had been lightly graded with a tractor and balde to get out the worst of the corrugations." He said.

Mr Todd also disagreed with evidence given to the court on Thursday that the road had soft edges at the time of the fatal accident. He said his definition of soft edges was "the edge of the road where the road had been waterlogged".

"Loose material is just the material which moves across the surface of the road." He said. "There was no indication that the road had subsided or collapsed."

(Ed: Impossible to drive for 15mins at 30 kmh? Ask any city worker caught in normal city conditions just how possible this is!)

Police accident investigations officer Sven Mason told the inquest that he would like to see the road at the accident scene widened to 5 m or 5 ½ m, so traffic could move safely both ways. ***Const. Mason said he had measured the road immediately after the accident. It was then 4.6m wide, but the road was now only 4m wide following improvements which included construction of safety wire rails.***

He criticised the move by the State Government after the accident to reduce the speed limit on the road from 40kmh to 30 kmh***. "It is impossible to drive at 30 kmh for 8 km", he said.***

THANKS TO MY ADVISORY PANEL
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