

# A massive understatement on Australia's economic outlook

## No one would dispute it

by Michael Collins, Investment Commentator at Schroders

The Netherlands economy expanded from 1982 to 2008 due to the ability of this small trade-focussed country to capitalise on the globalisation of that era. The 26 calendar years (or 103 quarters) of uninterrupted expansion is regarded as the record growth spurt for a modern industrial economy.<sup>1</sup>

Australia is close to outdoing that feat, an achievement no one predicted when the economy resumed growing 25 years ago. Our economy's expansion of 0.5% in the June quarter marked 100 quarters without a contraction.<sup>2</sup> The resources boom, the microeconomic reforms of the 1980s and the healthy budget position of 2008 that allowed an adept response to the global financial crisis have helped fan Australia's continuous growth since mid-1991.

But recessions are capitalism's ways of correcting the imbalances that expanding economies ferment. Australia's long expansion has allowed two debt-based distortions to fester. These debt blowouts will be paramount in deciding how Australia's economy performs in coming years. The threat posed by these imbalances, however, is contentious. One way to express how these debt excesses might hamper Australia's economy is to frame their likely jolt in a mighty understatement.

To be sure, Donald Horne's ironic title for his book *The Lucky Country* could prove true again. Another commodities boom and Australia's economic outlook brightens. Apart from being resources rich, Australia is a politically stable liberal democracy with sound institutions where inequality is largely in check. Such countries do best economically over the long term. No recession appears imminent. Consumers are spending, the jobless rate is at a three-year low of 5.6%, inflation is tame, a lower dollar is encouraging exports and the government is boosting investment.

But that won't be enough to stave off all challenges, particularly those posed by the debt imbalances. Australia's problem is that consumers owe a record amount of debt and foreign borrowings are at unprecedented heights. These distortions point one way when considering Australia's longer-term outlook.

### Linked excesses

The last time Australia was in recession was in 1991 when the population was 17.4 million compared with 24.1 million today.<sup>3</sup> Over those 25 years, gross domestic product has expanded 220% in real terms. GDP per capita has soared 59% to \$68,903 over the period, keeping Australia among the world's richest countries.<sup>4</sup> Much of that growth was due to worthwhile reforms grounded in free-market economics. Better competition policies allowed efficient domestic businesses to flourish. The floating of the dollar in 1983, the reduction in tariffs in the 1980s and more flexible labour markets promoted international competitiveness. Then there was

<sup>1</sup> IMF. World Economic Outlook Database. Netherlands gross domestic product, constant prices percent change. <http://www.imf.org/external/pubs/ft/weo/2016/01/weodata/index.aspx>. Quarterly numbers comes from media reports.

<sup>2</sup> For comparative purposes IMF. World Economic Outlook Database. Netherlands gross domestic product, constant prices percent change. <http://www.imf.org/external/pubs/ft/weo/2016/01/weodata/index.aspx>. Australian Bureau of Statistics. 5206.0 – Australian National Accounts: National income, expenditure and product, Jun 2016. Time series spreadsheets. Table 1. Key National Accounts Aggregates. Gross domestic product: Chain volume measures percentage changes. Series ID A2298668K. The economy last shrank in the June quarter of 1991, when it contracted 0.4%. It recorded zero growth in the following quarter and has expanded ever since. <http://www.abs.gov.au/AUSSTATS/abs@.nsf/DetailsPage/5206.0Jun%202016?OpenDocument>

<sup>3</sup> Australian Bureau of Statistics. 3105.0.65.001 – Australian historical population statistics, 2014. (Latest available). 18 September 2014. <http://www.abs.gov.au/AUSSTATS/abs@.nsf/mf/3105.0.65.001>

<sup>4</sup> IMF. World economic outlook database. GDP and GDP per capita at constant prices. Updated 19 July 2016. <http://www.imf.org/external/pubs/ft/weo/2016/01/weodata/index.aspx>



the mining boom, which boosted the prices of key exports more than threefold from 2004 to 2011.<sup>5</sup> But the economy was propelled by consumer and foreign debt that, due to the limits of driving growth this way, now threaten future prosperity.

Our growth spurt has only occurred because foreign lending has helped fund 43 straight years of deficits on the current account, the broadest measure of a country's trade with the rest of the world. Australia's net foreign debt stood at \$1.04 trillion on June 30 just gone. This is equal to a record 63.8% of GDP,<sup>6</sup> a high ratio by global standards, and up from 37% in 1991. About \$438 billion<sup>7</sup> of our gross foreign debt of \$1.9 trillion<sup>8</sup> has a maturity of less than 90 days. Australia needs to borrow this amount regularly for our economy to function. At some point, foreigners could demand a much higher return on Australian debt to justify their risk. A lending freeze would be lethal for the economy and the financial system.

Household borrowing is at levels that are just as menacing. The ratio of household debt to disposable income has jumped from 34% in 1991 to a record 154% now.<sup>9</sup> At some point, households will prioritise repaying debt over spending. The economy, which is about 56% driven by household spending, will falter.<sup>10</sup>

Both these types of debt have driven asset prices, especially on homes, to troubling heights – these debts are linked because banks sold debt securities to foreigners and lent the money to people who bid up housing prices (a case where the capital account drives the current account). According to the OECD, Australian housing prices are 29% overvalued against income and 48% overvalued against rent, making our residential property among the most overvalued in the world.<sup>11</sup> Other measures can give scarier assessments.

### Limited ammunition

There is no level or ratio where a debt automatically triggers mayhem, it must be acknowledged. Foreign and household debt ratios could climb higher without causing a ruffle if interest rates stay low. Debt repayments on foreign debt, for example, only amounted to 11.4% of exports in the June quarter, an acceptable level ratio thanks to record low bond yields.<sup>12</sup> But given these unprecedented debt levels and record home prices, it's easy to imagine pessimistic scenarios for Australia's economy whereby a vicious cycle kicks in. Higher interest rates, for instance, would hurt households repaying excessive mortgages. Any forced selling could destabilise housing prices, just as steeper borrowing costs are deterring borrowers. At some point, higher global interest rates could boost interest payments on foreign debt. That could slash the dollar, which would reignite inflation and justify higher local rates. A reluctance to lend or invest by foreigners could trigger the foreign debt crisis that was a concern in the 1980s.

International shocks are bound to emerge that could swamp such a small globally exposed debt-saddled economy such as Australia's. If things go wrong, policymakers will face the task of righting the economy. They, however, have fewer traditional tools to work with. Net federal government debt is expected to reach 18.5% of

<sup>5</sup> Reserve Bank of Australia index of commodity prices. In SDR terms, the index rose from 48.6 in January 2004 to a record high of 172.5 in July 2011. 1 September 2016. <http://www.rba.gov.au/statistics/frequency/commodity-prices/2016/icp-0816.html>

<sup>6</sup> Net foreign debt ratio to GDP. Series A3572045W from Table 35 Selected international account ratios: seasonally adjusted - quarter. (Series starts in September quarter 1988.) Australian Bureau of Statistics. "5302.0 – Balance of Payments and International Investment Position, Australia, Jun 2016." 6 September 2016.

<sup>7</sup> Australian Bureau of Statistics. 5302.0 – Balance of Payments and International Investment Position, Australia, Jun 2016. "Table 18. Currency and residual maturity of foreign debt – quarter." "Liabilities; less than or up to 90 days total (currency). Series A3536786J." 6 September 2016. This figure includes derivatives. More information on the maturity of foreign debt can be found in the ABS' "Survey of foreign currency exposure 5308.0" last conducted in 2013.

<sup>8</sup> Australian Bureau of Statistics. 5302.0 – Balance of Payments and International Investment Position, Australia, Jun 2016. Table 17. Gross external debt liabilities: levels – quarter." "Gross external debt. Series A3484170J." 6 September 2016.

<sup>9</sup> Reserve Bank of Australia. "Housing finance – selected ratios – B21." Series BHFDDIT. "Ratio of household debt to annualised household disposable income." 27 March 2015. <http://www.rba.gov.au/statistics/by-subject.html>

<sup>10</sup> Australian Bureau of Statistics. Australian National Accounts. National income expenditure and product. 5206.0. June quarter 2016. 7 September 2016. Table 4. Expenditure on GDP. Chain volume measure. Trend 2015-16. Page 26. [http://www.ausstats.abs.gov.au/ausstats/meisubs.nsf/0/928CEC79B6328850CA2580260012EF43/\\$File/52060\\_jun%202016.pdf](http://www.ausstats.abs.gov.au/ausstats/meisubs.nsf/0/928CEC79B6328850CA2580260012EF43/$File/52060_jun%202016.pdf)

<sup>11</sup> The Organisation of Economic Cooperation and Development. Economic outlook, analysis and forecasts. "Focus on house prices." September 2016. <http://www.oecd.org/eo/outlook/focusonhouseprices.htm>

<sup>12</sup> Interest income on foreign debt divided by export income. Australian Bureau of Statistics. 5302.0 – Balance of Payments and International Investment Position, Australia, Jun 2016. "Table 11. Income debits – quarter." "Primary income debts, investment income, portfolio investment, income. A3529701C." Interest bill on foreign debt paid for June quarter is addition of columns L, Z and AN (\$8.8 billion) divided by exports for the three months (\$77.4 billion). Column L is "direct investment interest", Column Z is "portfolio investment interest" while column AN is "other investment interest".

GDP in 2017-18, not high by international standards but up from below zero from 2005-06 to 2008-09.<sup>13</sup> The excessive political focus on government finances (especially compared with the largely ignored household and foreign debt sprees) will make it harder for Canberra to mount another recession-thwarting rescue mission. The Reserve Bank of Australia's 12 interest-rate cuts since late 2011, which have lopped the cash rate from 4.75% to a record low 1.5%, leave it with little conventional firepower. The RBA could be forced to turn to unconventional tools now common overseas such as central-bank asset buying or negative interest rates. But they only stave off deeper woes. They don't mend economies.

By this time next year, Australia could have smashed the Netherlands' record for the longest expansion. But when investors consider the debt imbalances in Australia's economy they probably wouldn't argue with this understatement: the next 25 years are unlikely to be as smooth, as buoyant and as crisis-free as the past quarter decade.

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<sup>13</sup> Australian government. Mid-year economic and fiscal outlook. Appendix D: Historical Australian government data. "Table D4: Australian government general government sector net debt and next interest payments." December 2015. [http://www.budget.gov.au/2015-16/content/myefo/html/16\\_appendix\\_d.htm](http://www.budget.gov.au/2015-16/content/myefo/html/16_appendix_d.htm)