OPINION

THE AUSTRALIAN ECONOMY AT A CRITICAL JUNCTURE

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Australia is considered by many mainstream economists to be a strong, stable and growing economy, in large part due to its performance over the last decade, according to conventional measures compared to other developed economies. Australia's long run of GDP growth, relatively low inflation and relatively low unemployment suggest that the nation is well placed to continue 'outperforming' most other developed economies and to deal effectively with any potential downturns.

However, looking beyond the mainstream economic indicators, other measures indicate that Australia is facing a critical juncture in its political, social and economic history, with implications for future workforce participation, social structure and culture.

Wages growth, consumer and business confidence, and retail spending are either lagging or declining relative to the levels seen in the years prior to the 2008 'global financial crisis'. Recent business investment has been dominated by mining investment on the back of the commodity price boom driven by Chinese economic growth, as China has become Australia's largest export destination, accounting for more than 30% of the value of exports. This linkage has increased Australia's exposure to the ongoing performance of the Chinese economy. The mining boom is now fading, with investment dropping as commodity prices fall sharply in the wake of increasing global supply and slowing Chinese economic growth.

Money printing, or quantitative easing (QE), by the central banks of the world's largest economies has pumped massive amounts of liquidity into the global financial system and driven asset prices up around the world. This increased liquidity has led to an interest rate premium of 1.5% on average for 10 year government bonds compared with the equivalent US rate since the early 2000s, attracting large volumes of foreign capital. This has seen Australia's net foreign debt increase significantly to around 60% of nominal GDP.

Financial Problems

The financial sector has accounted for the majority of the increase in non-government foreign debt in the last twenty years, via offshore bond issuance. This has increased the availability of domestic credit and lowered the cost of borrowing, with household debt levels increasing dramatically over the same period. Interest payments as a share of disposable income rose in line with the debt level until the RBA began cutting the official cash rate in 2008, lowering household debt servicing costs despite record debt levels. This has, in turn, increased the potential for asset bubbles (particularly in Sydney and Melbourne property), with capital city house prices increasing significantly during this period, driven higher still by both local investors facing limited investment alternatives in a low interest rate environment and offshore investors looking to place capital in stable democratic economies.

The current federal government is facing a backlash from voters (irrespective of the leadership change from Tony Abbott to Malcolm Turnbull) due to perceptions that it has not done enough to protect local property buyers from foreign investors. The property market is not subject to the same level of scrutiny as the financial sector, leaving the Australian property market exposed to the potential for money laundering and 'safe haven' investments. A crackdown on corruption in China by its government, as well as slowing economic growth, has led to an increase in wealthy individuals moving capital offshore and into stable democratic economies. There is evidence that an increasing amount of this capital has made its way into the Sydney and Melbourne property markets under the Australian government's temporary/permanent resident investment rules and special investor visa schemes, despite there being a Chinese government limit of US.$50,000 for citizens moving capital out of China. The Foreign Investment Review Board is engaging in increasing scrutiny as to the legality of foreign buyer transactions and has recently stepped up its monitoring and investigations in an attempt to counter this trend. This process may lead to a drop in this segment of demand for property, which has accounted for as much as 25% of new dwellings. This would likely lead to lower capital inflows and lower house prices.

Australia's financial sector has a strong regulatory and governance framework, comprising the Australian Prudential Regulation Authority (APRA), the Reserve Bank of Australia (RBA) and the Australian Securities and Investment Commission (ASIC). The latest round of banking regulation (Basel III) is in the process of being implemented with a new ratio, the Liquidity Coverage Ratio (LCR), requiring banks to hold sufficient liquidity to withstand a 30 day crisis, implemented on 1 January 2015. This has strengthened the banking system's ability to deal with a short term liquidity shock but has not materially changed the underlying structural liquidity mismatch associated with funding 30 year mortgages predominantly with short term customer deposits and offshore wholesale funding. The four Australian major banks are heavily exposed to residential mortgages, which have relatively low capital requirement risk weights. Although APRA has recently directed the major banks to raise additional capital, bringing them in line with their global peers and increasing their ability to withstand a downturn, this leaves the financial sector exposed to a downturn in property prices and loan arrears. The risk of foreign capital outflows caused by a pick-up in activity in larger developed economies (with the associated higher potential returns for an equivalent level of risk) is affecting the local banks' cost of funds and potential ability to refinance maturing debt obligations.

Housing at Risk

These factors make home ownership risky for some and very difficult for many. Historically, home ownership, 'the great Australian dream', has played a critical part in Australian culture and has been a strong motivator for hard work, household saving and, more recently, self-funded retirement. Government policy has been (since 1945) designed to support high levels of home ownership complemented by adequate public housing. However, as house prices have risen and affordability has decreased, social and affordable housing solutions have not been implemented. This has disproportionately affected lower income, less wealthy individuals who do not have access to assistance from family members. With the working age proportion of the population set to decline over the next 30 years and an increasing proportion of government budgets to be spent on health and aged care services for the ageing population, policy should be supporting the continuation of home ownership for current and future generations, and to continue to encourage hard work and household saving.

Unabated, the combination of these economic, political, social and regulatory factors is likely to constrain growth in Australia's economy over the near to medium term and may lead to a significant correction in house prices, particularly in Sydney and Melbourne, over the next two to three years. Capital outflows to large economies such as the U.S., as they unwind QE and begin increasing official interest rates, would adversely affect the Australian banking system's cost of funds and potential ability to roll over maturing debt, with flow-on impacts on the availability and cost of credit to sustain already high property prices.

Increasing Inequality

Even if Australia manages to avoid a major housing market correction and foreign capital outflows, unless the government implements policies to continue to support home buyers, even at the expense of both domestic and foreign investors, there is a risk that home ownership will fall out of reach for all but the wealthiest families. Increased economic inequality will make Australia a society divided between investors and workers, seriously undermining its purportedly egalitarian culture.

Government policies reducing public funding of higher education, social welfare and family support have increased reliance on labour income. However, at the same time, both major federal political parties have maintained negative gearing and capital gains tax discount policies which favour returns on capital and penalise labour income, which has added to capital accumulation, wealth concentration and growing inequality. These policies have primarily benefited existing property owners and investors, who are over-represented by the baby boomer demographic voting bloc that benefitted from the housing price increase and associated wealth effect following the deregulation of the banking system in the 1990s. House price increases over the last twenty years have significantly exceeded wages growth, CPI and rental costs. This has been compounded by longer life expectancy, coupled with government policies aimed at keeping older people in their homes for as long as possible, which mean that the historic cycle of housing turnover has slowed. Home buyers are being forced to take on increasing levels of debt in order to afford to buy a house.

This combination of current prices and policy settings may lead to a change in the incentives for participation in the workforce. Wealthy members of society will be likely to work less, relying instead on their return on investments to fund their cost of living. Perhaps even more significantly, less wealthy members of society will be more likely to opt out of workforce participation. If they are no longer able to share in the 'great Australian dream' and the associated motivation to earn, save and build wealth to self-fund retirement, they will instead rely on government pensions and services. All of this at a time when the proportion of working age population is falling and government health and aged care services costs are rising.

Regardless of the outcome, Australia faces a critical juncture in its social, political and economic history.

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