

URBAN LAND, HOUSEHOLD DEBT AND OVERSEAS BORROWING

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A Great Financial Crisis can only occur as a surprise. If it is anticipated by the financial players, there may be a series of little financial crises as the players adjust their expectations but the imbalances which cause great crises will not build up. Great crises are therefore consequences of selective blindness. They result from disregard of the first and perhaps only worthwhile lesson in economics, which is that everything depends on everything else.

Despite the plague of dishonest accounting (itself a sign of trouble), in the boom which begat the current GFC the selective blindness was not due to lack of data – throughout the boom the national accounts of the Anglophone countries documented an unsustainable reliance on growing consumer debt as a source of demand. The blinkers were imposed by neo-liberal economics, that legacy of European intellectual turmoil and American Cold War evangelism which became the hegemonic economic theory following the end of full employment. This was ultimately an economics of *process*: provided all economic decisions were subject to demand and supply in competitive markets, the invisible hand would guarantee economic efficiency and the optimum use of resources. This being the case, there was no perceived need to check the macroeconomic balance sheets for signs of impending trouble. With honourable exceptions, faith in competition brought blindness, and this ingrained faith still hinders an appreciation of what went wrong. For a full appreciation of present problems, it is necessary to examine the macroeconomic balance sheets (ABS 2008).

What Went Wrong?

From an Australian urban point of view, the place to begin is the urban balance sheet. There is no official version of this, but we know the major trends. From 1994 or thereabouts Australian cities went through a land boom. Site values increased faster than improved values; location value rose as a proportion of total urban assets (NIEIR: 2006 Ch.2). The capital gain was shared by the business and household sectors.

Why did site values rise? One clue is the steepening of the centre-fringe rent gradient, which broadly reflected changes in the accessibility of work. During the boom it was frequently claimed that the increase in employment in the CBDs and inner suburbs reflected the growth of the knowledge economy, and there was certainly an element of this. However, the bloating of the finance sector added to CBD employment growth while the decline of the manufacturing sector reduced employment growth on the urban periphery. The rent gradient also steepened as a result of the full exploitation of motoring technology. In the 1950s the adoption of universal motoring had allowed the decentralisation of employment and the infilling of green wedges. By the 1970s the wedges had been filled and readily-decentralised employment had been spread around. Inner urban streets had become congested as cross-town traffic was added to traffic with local origins and destinations. The simple engineering solution to falling road speeds – increased road space – proved to be highly expensive, particularly when externalities were taken into account. The combination of the centralisation of work and falling road speeds increased the relative accessibility of work from the inner suburbs. Inner urban site values rose, precipitating both gentrification and redevelopment.

However, this was not the whole story of the land boom. An essential ingredient was bank promotion of residential mortgages. To the neo-classically blinkered this was no problem – after all, the mortgages were contracted between private parties assumed to be fully aware of all risks. From a bank point of view, residential mortgagees could be charged higher interest rates than other borrowers (big business had direct access to financial markets) yet mortgage lending seemed secure since there was land as collateral and if all else failed the borrowing household could

repay upon retirement from lump sum superannuation payouts. From the household point of view, the established advantages of entry into home ownership via mortgage borrowing were compounded by the discovery that extra consumption could be financed by extending the mortgage, not to speak of the joys of capital gains financed by negative gearing. As in booms more generally, selective blindness set in. The rising claim of debt servicing on household income increased the riskiness of mortgage loans, but this was ignored. Similarly the falling affordability of residential land to new market entrants put in question the sustainability of land prices, and hence the value of collateral, but this was also ignored.

A major increase in mortgage lending to households was the main change on the asset side of bank balance sheets during the boom. The corresponding increase on the liability side was borrowing from overseas. All of this seemed profit-maximising when it was undertaken but has landed the banks with two major exposures: exposure to household loan default and exposure to overseas financial markets and the costs and uncertainties of refinancing overseas debt.

The macroeconomic balance sheets thus document three problems – overvalued urban land, over-indebted households and a banking system over-exposed to overseas borrowing. Cries of alarm, including those from the National Institute of Economic and Industry Research in its *State of the Regions Reports*, were hushed by the neo-liberal establishment with the claim that competitive markets guarantee optimum and equilibrium.

Market Failures

Why have the macroeconomic balance sheets become financially unsustainable?

For Australia, looking at the balance of payments is a good place to start. Imports and debt servicing have persistently exceeded exports, financed largely by further accumulation of overseas borrowing by the banks. In neo-liberal theory free trade in currencies guarantees equilibrium in the balance of payments, but in practice the price responses are completely unhelpful. In particular, correction of a balance of payments deficit

requires the deficit country to invest in the industries producing tradeable goods, but a fluctuating exchange rate discourages such investment by adding to the risk that the exchange rate will be high and so kill the profitability of investment at the crucial time when profit is needed for cash flow.

Market forces are also supposed to guarantee that overseas borrowings are invested in ways which generate flows of foreign exchange with which to service the debt. However, under the market forces prevailing during the boom the banks found it more profitable to lend to households on mortgage than to lend to trade-exposed business. Not only did this lending fail to strengthen the trade-exposed sector; because of the limitations to the supply of accessible urban land it even failed to generate much of an increase in dwelling supply, instead spilling over into land value increases on the asset side and consumption increases on the expenditure side.

As regards the household sector income and expenditure account, land boom borrowing more than negated compulsory saving through national superannuation. Via the financial sector, overseas borrowing had a counterpart in the disappearance of household saving, crowded out by consumption.

Apart from the disappearance of saving, a remarkable element in the household sector income and expenditure account (compared to the decades before deregulation) was persistent heavy reliance on social security income. The data required to disaggregate the drivers of Commonwealth social security expenditures were suppressed as part of the overhaul of the public accounts in 1998, but take-up rates testify that the end of full employment continues to account for much social security receipt. This is partly a matter of geography – social security take-up is high in regions which suffer from failed industries and in general combine poor employment opportunities with affordable housing. Take-up is also high in the ‘lifestyle’ regions, whose populations have increased as land-boom capital gains encouraged retirees from the city to sell-up and shift to the beach, always carefully arranging their finances to come in under the means test. More fundamentally, the under-utilisation of labour reflected in high social security take-up disproves the neo-liberal faith that full employment can be guaranteed by movements in

real wages. There is, for a start, the strong complementarity between particular skills and particular types of equipment – and both the skills and the equipment commonly take decades to acquire. Again, work is a social activity, and lack of attention to the social aspect of work can result in both wasted resources and in over-utilised resources.

Despite the accumulation of warning signs in Australia, the GFC was triggered in the USA. Its main immediate effect in Australia was psychological – a reassessment of financial asset values – but it was plain that exports would soon be affected and that the refinancing of overseas debt was likely to become difficult. The banks had already had a foretaste of the latter problem (from 2007 they were unable to offload securitised mortgages) and were poised to implement a credit squeeze.

Governments across the OECD, including many governments which were already heavily in debt, reacted by borrowing and spending, in the hope that a Keynesian stimulus would bring a return to business as usual. In a volte-face compared to its behaviour during the Asian crisis, the IMF approved of stimulation. Comforted by the implied promise that the IMF would help with the resulting increases in the balance of payments deficit, the Commonwealth of Australia felt confident to join the stimulators. But herein, for Australia (and the USA), lies the weakness of stimulation: the boom was doomed because of its dependence on overseas savings. Stimulation in deficit countries which does not include measures to reduce overseas borrowing is liable (at best) to peter out as more and more domestic income is absorbed in debt servicing and (at worst) to end convulsively with a collapse in the exchange rate.

This is but one facet of the exquisite policy quandary which is the Commonwealth's inheritance from neo-liberalism. Addressing the balance of payments constraint requires an increase in saving, but increased saving is the opposite of stimulus. Worse than this, the market mechanism to address the balance of payments deficit is depreciation in the exchange rate, but this would bankrupt the banks and negate the policy of stimulus. Addressing housing affordability requires deflation of land prices, but that is also the opposite of stimulus. Add climate change to all this and it is no wonder that confusion is widespread in a policy elite schooled to think in neo-liberal terms. The only certainty is that unemployment will increase.

The certainty of rising unemployment arises not only from the limits to stimulus, but from the need for an economic restructuring much more drastic than the neo-liberal restructuring of the 1980s and 1990s. Economic restructurings involve reductions in output in some industries, counterbalanced by increases in others. At best this precipitates frictional unemployment. In the 1980s, through inattention to retraining and similar inattention to investment complementary to the skills on offer, it generated a lost cohort of deskilled workers. This time round, the worry is more that the transition requires a rapid change in both producer and consumer expectations. Needless to say, economic restructuring is resisted by the losing parties, as for example the fierce resistance of the carbon lobby to greenhouse gas emission abatement policies (Hamilton 2007, Pearse 2007). The need for financial arrangements to underpin the restructuring provides the losers with opportunities for resistance which increase the ultimate cost – whether expressed in unemployment or in reduced incomes. Where one of the losers is the finance sector itself these opportunities are magnified.

Beyond Market Measures

Given the seriousness of the quandary, governments which genuinely wish to minimise the increase in unemployment (and the waste of resources which this implies) have no option but to go beyond market measures. An example where we can learn from Australian history is the balance of payments, where as we have seen the market nostrum of exchange rate depreciation is simply not feasible in the present condition of bank balance sheets, and would not work anyway since business is understandably wary of fluctuating exchange rates. Far better to control the exchange rate at a believable level – preferably on the low side, with controls over capital flows if necessary – and apply alternative policies. Australia has long if not always highly successful experience with the support of tradeable production. Industry policy can be revisited, ideally at the expense of non-tradeable activity such as the finance sector rather than by transfer of resources from the more successful tradeable industries to the less. The balance of payments also benefits if consumer demand switches from import-intensive purchases to domestic purchases.

For example, an increase in taxation, spent to household benefit on education and health services, would benefit not only the balance of payments but would reduce carbon emissions (education and health services being two of the least carbon-intensive of Australia's industries).

A second example where reliance on market solutions is bound to fail is greenhouse gas emission abatement. The proposed market measure is emissions trading which is expected to generate price incentives to reduce the carbon intensity of production (especially electricity production). The danger is that the abatement target will be met by shutting down emissions-intensive production with nothing to replace it – in other words, by reducing economic activity and increasing unemployment. The decarbonisation of electricity requires active government investment. Once it is under way, a further important step will be the electrification of transport (battery cars, electric railways), a step which will have the further benefit of reducing imports, particularly if the electrical equipment can be manufactured locally.

And what of that most difficult imbalance of all, the imbalance that was at the heart of the boom – the urban land market? Is there an alternative to the deflation method of bringing land prices back to affordable levels? Theoretically, land prices can be brought back into line by holding them in nominal value while other prices and incomes are inflated, but it may turn out that the answer is a combination of CPI-inflation and land price deflation, both at manageable rates. Meanwhile the challenge is to address the underlying accessibility patterns, both from the land use and from the transport side.

These three examples testify to the major adjustments asked of all sectors of society. If aspirational consumers are unable to increase savings and switch consumption patterns, the result will be delayed adjustment and high unemployment. If the carbon and finance lobbies postpone adjustment, the eventual changes will be cataclysmic and will generate high unemployment. If commentators, politicians and governments insist on continuing to apply neoliberal economics, the result will be delayed adjustment and high unemployment.

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