THE FINANCIAL OUTLOOK FOR AUSTRALIA
(WITH DOWNSIDE APPREHENSIONS)

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Prepared by Ian Manning, Senior Fellow,
National Economics (NIEIR)

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Our business-as-usual projection is neither exhilarating nor depressing.
The recent burst of high net immigration is unlikely to continue.
This is a business-as-usual projection, so employment growth echoes population growth.
Under business-as-usual, low inflation is likely to persist for a few years before rising as the exchange rate depreciates.
The authorities are likely to persist with the present low interest rate policy till the necessity to finance the balance of payments deficit forces a reckoning. For business-as-usual to continue it is necessary that the increase be small enough to avoid mass bankruptcies or large falls in asset prices. After this, a return to the long-run ‘normal’ is to be expected.
BUT: business is not usually ‘as usual’. There are upsides and downsides.

In Australia both ups and downs are mostly imported via export markets, particularly resource-based exports.

The mining boom is an example of a well-timed, unexpected upside.

Will there be others? What about a boom in hydrogen exports?

Though downsides mostly originate overseas, the risk depends on the strength of domestic balance sheets. In our book *Credit Code Red* (Melbourne, Scribe, 2017) Peter Brain and I considered the possibility that Australia’s current run of economic growth will end in crisis sometime in the next five years.
World economic stagnation

A background of reduced growth in world gross product along with low real interest rates.

(Falling interest rates have brought capital gains, but in due course increased capital values generate reduced equity returns.)

Could stagnation be a supply-side story?

This would be like the 1970s OPEC stagnation: but there’s little sign of capacity-constraint inflation.
Could stagnation be an equilibrium story?

If free markets deliver what people want, and markets are free enough to do so, perhaps GWP growth has slowed because people want more leisure and less GWP-goods.

Maybe true in some countries – but there’s also evidence of involuntary unemployment and underemployment, and what of the unmet needs of the world’s poor?

So stagnation becomes a demand-side story? (Not enough sales to generate full employment of labour and capital.)

Maybe this is due to world population ageing, generating an over-supply of goods and services marketed to young families. So why not switch production to old people’s goods and services? But maybe the elderly cannot pay for what they want.
There are also stories of demand and supply in dynamic disequilibrium

Low interest rates and capital gains generate rentier incomes and income inequality. Despite the claim that inequality is necessary for incentives, increased inequality dampens GDP growth. Suggested reasons:

- failure to utilise the talents of the poor;
- misaligned incentives; and
- inability to reorient production away from mass production to the status goods of the rich.

In addition, maybe productivity growth due to technical change has outrun the demand for goods and services that have become much cheaper (manufactured goods, telecommunications, some elements of transport). Is there a need to contract production of high-productivity goods?

Sadly, these stories sound like a zero-sum game. Add in the climate crisis and it is not surprising that big nations and big businesses are jockeying for power. There are both hot wars and trade wars. The likelihood of a financial crisis originating overseas is increasing. Is Australia prepared? Let’s look at the balance sheets.
The story of Australia’s balance sheets

A robust balance sheet carries little debt both in relation to assets and in relation to the capacity to service debt.

We consider sectoral balance sheets: governments, households (including non-corporate business), nonfinancial corporate business, financial corporate business.

Debt is not equity. It is prudent to limit it to what can be serviced even in adverse circumstances. Overseas debt requires particular prudence.
P = prudent. O = over-stretched

The 1880s land boom: households O, colonies O, intermediaries O.

The first half of the 20th Century: households P, government P, finance P – not, however, a golden age thanks to slack demand. Depression and World War II.

The post-war period: households P, government P, banks P, nonbank financial intermediaries O – a golden age thanks to buoyant demand, but eventually income claims were mismanaged, resulting in the 1970s stagflation.

The 2000s and to date: the banks specialised in mortgage lending which:
- can be serviced from rental savings;
- thanks to computers, is cheap to administer;
- is backed up by superannuation lump sums; and
- is further backed up by property collateral.

Immediate consequences:
- a boom in urban land (housing demand greater than could be serviced by the creation of accessible house sites);
- substitution of consumer demand for government demand (hence the infrastructure backlog, including slow rate of creation of new accessible house sites);
- accumulating household debt; and
- accumulating (net) overseas borrowing by the banks.

Longer term consequences:
- household debt saturation;
- an infrastructure backlog;
- failure to diversify exports; and
- vulnerability to overseas short-term lenders.
Summed up by balance sheets:

- in the banking sector, an increase in overseas borrowing balanced against an increase in mortgage lending to households;
- in the household sector, an increase in mortgage borrowing balanced against an increase in the value of land and superannuation assets; and
- for Australia as a whole, an increase in net overseas debt balanced against an increase in the value of land.

Resemblance to 1890? Households O, finance O, nationally O but governments P.

Resemblance to 1975? Income claims quiescent, but the end of a policy era.

But is this time different?

- **Technologies:** the need to invest to keep up to date.
- **The climate crisis:** a need to invest to maintain effective capital intact (ideally funded from depreciation, but stranded assets are all too likely).
What’s the probability of an Australian GFC? Despite precedents set elsewhere in 2008, it is difficult to predict what will happen after either the household or financial sector strikes difficulty in debt servicing. Mass write-offs of domestic debt are difficult enough to manage and international write-offs are very difficult indeed. The mayhem will be best survived if the Great Financial Reconstruction aims at increased exports, curbed imports and environmental sustainability. This will require:

- a rethink of macroeconomic management;
- increased saving and investment; and
- increased taxes.

(NB: national superannuation failed to raise household savings rates and reduced tax revenue.)