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HD **Debt of a thousand cuts to stifle growth**

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Australians are complacent about paying for the lifestyle we want

A PASS mark for your first federal budget, Prime Minister, but your job has only just begun because you and your colleagues will need to display strong leadership to take the Australian people with you, and you will need to provide a clear message that the "fix it" journey has just begun.

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Given you have inherited an economy where your predecessors clearly misunderstood the way their actions affected the Australian people economically, one could observe given the negative reaction that we have become complacent with single-issue groups retarding our competitive development.

I have read the commentary on the National Commission of Audit, all the budget commentary from the textbook economists, the chardonnay socialists and the single-issue groups, but no one has yet prescribed how we are going to regain our competitive advantage, restore value on a sustainable basis, plus provide opportunities for our youth unemployment pool.

When you listen to the tone of commentary on the budget, one could also conclude that we have become a "single issues" nation, more intent on selfish pursuits or ideology rather than trying to understand the state of our economy.

Research carried out by Michael Enright and Richard Petty for CPA Australia found that the country does well in assessments of quality of life, political and social stability, education and some measures of capability. But it does not compare well in terms of links to the global economy, infrastructure, complexity of taxes and regulation, brain drain, supply chain and industry clusters.

On these drivers it tends to lag behind global leaders as well as some economies in the Asia-Pacific region. We are clearly forgetting the opportunities for this country in the region, which has a population of 4.3 **billion**, growing to 5.2 **billion** by 2050.

Given the emotion around some of the cost cutting, austerity measures seldom work without structural reforms such as changes in taxes, regulations and labour market policies. If these are poorly designed, not only is productivity inhibited but they can disproportionately hit the poor and middle classes.

Obviously change of any description has to be sold to a population that is yet to be persuaded that someone has to pay for all the things we want to do as a society.

The chart on nominal gross domestic product growth shows how fast our economy is moving.

I have used nominal GDP because it is the total dollar value of all final goods and services produced during a year — it is measured by adding up what people and businesses actually spend for things in a year and it is also a useful guide as to how our tax revenue is developing.

Clearly this trend is not encouraging, and given the focus of the recent G20 conference in Sydney to lift real economic growth by 2 per cent during the coming five years, then we cannot expect much assistance from external sources.

Ultimately, growth in any country is predominantly driven by myriad businesses making decisions to add value, and for households to spend and invest.

The governor of our Reserve Bank, Glenn Stevens, summed up the frustrations of many of us nicely when he outlined his agenda to shift the conversation away from growth versus austerity, to discussing more of what we had to do to spur growth potential.

We have seen some of the government's growth plans and some of the things have political connotations that claim they will help growth — I am sure that debate and politics will rage through the 24-hour news cycle for a while.

Stevens also highlighted the challenges associated with the transition of our economy from **mining** to non-**mining** investment and had some insightful comments about fiscal sustainability and the demographics of more people moving into retirement and fewer entering the workforce in the years ahead.

The missing commentary has been about the level of indebtedness around the world and the fact it is not reducing. Public and private debt in major economies of the world continues to move higher and some academic research has shown that a public and private debt-to-GDP ratio above the range of 260 per cent to 275 per cent has a depressive impact on economic growth. If this research has some validity, then the G20 goal of increasing growth by 2 per cent may be another optimistic figure produced by the central banks of the world.

As the table detailing debt shows, growth opportunities seem to be diminishing (as reflected in the GDP trend) and if the academic research that is now beginning to record that a public and private debt can have a depressing impact on economic growth, then how do we counteract the negative pull from a black hole of debt, some of which may never be repaid?

Our nominal GDP is running at $1.5 trillion; commonwealth government debt is $284 **billion**; government debt of the states is $231bn; non-financial corporate sector debt is $1.06 trillion; household debt is $1.7 trillion.

Our public and private debt-to-GDP ratio, based on the figures above, is 217 per cent. It is not in crisis territory yet but, unless we stop analysing debt as commonwealth government only, then we will head to that black hole of debt, which must be serviced from cash we all generate.

WHEN you talk about a country's debt, it is always risky as many people have a different view on its effect on an economy.

If one talks about government debt then it is important to understand the nature of the debt. Is it in the government's own currency, has the debt been incurred by freely printing money? (Japan, the US and Britain have engaged in such practices.) How much debt is external?

Also, how much accrued liability is undisclosed? Do governments disclose their contingent liabilities associated with unfunded pension entitlements and other public service benefits? In Australia, do we take into account debt accumulated by the states and, of course, their public service entitlements?

My suspicion is that we do not adequately account for these liabilities in public discourse.

When looking at private sector debt, financial debt such as **bonds** issued by the banks can complicate the picture, although in Australia's case it is important to understand how much of the financial services debt it funded offshore and the risks that prevail in terms of refinancing the external debt at maturity. A country such as Britain, for instance, ends up looking as if it uses much more debt simply because the financial sector is a bigger part of the economy.

Do not misinterpret my concerns about debt. It can be a good thing when used properly. For instance, if debt is used to buy an income-producing asset, such as a new technology or a financial plan that increases commercial-industrial activity, then debt can be net productive.

The chart putting Australia's debt in a historical context comes from an insightful piece by Josh Kirkwood and his team from Bank of America Merrill Lynch. They tackle head-on that part of our debt that no one seems to want to highlight; that is our household debt.

Yes, government debt is relatively low by global standards but total debt is quite high, and it is more skewed towards households than in the past. We cannot ignore household debt in our national discourse since the bulk of the Australian stockmarket and economy is exposed to the consumer wallet.

 

At best this debt burden portends a long period of low growth for Australia because as you rack up debt you are bringing forward consumption.

When some people look at total debt, there seems to be a lack of understanding that to pay back debt, you must forfeit spending.

Notwithstanding the above, I was particularly pleased to see some analytical work carried out by Warwick McKibbin recently; he makes the point that further debt or debt in general would be “less bad” if it were used to generate a return that offset the cost of borrowing.

The problem is that Australia’s debt accumulation did not deliver the optimal returns. There has been little infrastructure investment through the so-called boom, and remedial measures undertaken such as stimulus cash payments and pink batts do not produce any ongoing return. Most debt taken on by households has been used to fund housing, not productive investments.

Given the size of household debt, central banks tried to stimulate growth by reducing borrowing costs to very low, sometimes record low, levels. Part of their hypothesis is that rising asset prices will make consumers feel wealthier and they will spend more.

I have been researching the wealth effect concept, which has been used in the US to justify the quantitative easing argument and growth expectations by the Federal Reserve, the principal argument being that the so-called wealth effect determines that an increase in consumer wealth — through higher stock prices or home values — will **lead** to increased consumption.

One report in the US reveals that it may be five to 10 times weaker than the Federal Open Market Committee had assumed, resulting in some overly optimistic growth expectations by the FOMC. The disturbing feature of this research is that if the FOMC has continuously been overly optimistic regarding economic growth in the US since 2009, then the US economy should have been about $1 trillion or 6 per cent larger at the end of last year. This was not the case and that is one of the reasons the FOMC forecasts are losing credibility.

Economists will tell you the wealth effect is a key theme underpinning most budget forecasts. In the budget just delivered to the Australian people, household wealth rose 11 per cent last year, driven by the stockmarket and house prices. Many textbook economists suggest this will allow consumption to grow more quickly than income as households run down savings, with flow-on effects to the economy and tax receipts. This is reflected in forecast revenue where the compound annual growth rate accelerates from 3.7 per cent to 6.6 per cent, driven by a big jump in personal income tax receipts. Only a small part of this is due to the 2 per cent debt tax.

I would challenge textbook economists’ strong faith in the wealth effect for two reasons. First, the empirical evidence is that wealth effects are relatively small on average but with a wide range of potential outcomes. That is to say, there are occasions where the wealth effect works and others where it does not.

Second, let’s assume we do get a small, positive transitory impact from the wealth effect from a reduction in the household savings rate. Surely the longer-run consequences of this are problematic? Households cannot reduce savings indefinitely, and we ought to be developing more sustainable plans for the living standards we seek for future generations. This aspect of the debate has been sadly lacking.

With that research I then examined our household debt-to-income ratios for five countries, including Australia. We now have the second highest leverage on this measure, behind Canada. Australia’s debt-to-income ratio has been constant at 150 per cent while other countries have been deleveraging through writing off or repaying debt.

So, in summary, the reality is that Australians have only modestly deleveraged and debt remains high by international standards. Australians have limited capacity for more leverage, which — in tandem with a move away from peak resource investment — implies subdued growth for some time. I believe it would be a mistake for the market to extrapolate the recent strong data into the future, particularly when the riskiest part of the transition away from peak resource investment is still before us.

Against this backdrop, how does Australia grow and raise living standards for our children and grandchildren?

Textbook economists can tell us how to make markets more efficient, getting more from the same inputs. That is a good thing and we should heed their advice. But that alone will not do.

 

Another crucial component is that we as a country and as individuals think about how we can build value.

WHAT parts of the economy can add value? And how do we foster a business sector with adequate access to funding and risk appetite to build that value and compete.

The competitive strategy literature focuses largely on prescriptions for management action — but if management's objective is to create value by investing at above the cost of capital, then sustainable value creation is the signature of competitive advantage.

It is worth looking at papers written by the RBA's Stevens, a landmark study commissioned by the CPA on Australia's competitiveness and a very good piece of work undertaken by the Grattan Institute on balancing budgets to present a couple of ideas that may help reverse our GDP growth trend line and re-establish the high standard of living to which we have become accustomed, and perhaps remove some of the complacency that has surfaced in those opponents to budget reforms.

From these documents I believe the following points are noteworthy: First, boosting competitive effort in markets that genuinely free up trade has been highlighted.

Clearly, the recent successful bilateral trade agreements with Japan and South Korea are good news stories, plus progressive negotiations with **China** is encouraging. Australia is one of the world's most efficient agricultural producers and is an advanced service economy.

In the absence of a global agreement on trade, bilateral and regional agreements could open up opportunities for other efficient industries to take advantage of any bilateral agreement and should be pursued aggressively.

Second, workforce-related drivers are among the most important for Australia going forward. The economy will go only as far as people can take it and, as most leading employers understand people are "intellectual assets" that make things happen, the cost of mismanaging them can be disastrous. Success goes to companies whose leaders motivate their people and unleash their competitive creativity and commitment.

Enhancing human capital, labour market mobility and participation are all topics that should be debated. Also, how do we encourage our school-leavers to undertake education that is not only in their interests but in the interest of the country?

A related issue, of course, is the confrontational workplace citation system that exists in Australia and does not go unnoticed in international markets. Business cannot exist without labour and labour should understand that if input costs rise faster than productivity then companies and industries cease to exist.

We have some way to go before we get compromise in this area and, until we do, this issue will continue to be a negative in investment decisions.

Third, how do we minimise distortions from tax? Tax systems are important in how capital is allocated in an economy, and for too long we have had a piecemeal approach to tax reform. I am cognisant of the political challenges but, equally, the necessity of recalibrating tax systems to be more efficient and effective, and therefore supportive of growth, should be a priority.

Compared with other developed economies, Australia's tax burden falls disproportionately on high-income individuals and corporations.

This may seem ideal for a progressive nation, or ideal if Australia were the only country in the world. However, it is not, and the high-income individuals, including senior managers, leading professionals and business owners and corporations may well consider moving to other locations that have a much lower personal and corporate tax rate if we do not make this issue a comparative advantage at least.

Fourth, we talk about infrastructure, and analysts and business groups in Australia have been lamenting for some time that there are significant gaps and much of the existing infrastructure is at or near its limits. Efforts to improve Australia's infrastructure appear to be hampered by a lack of understanding and agreements to key development needs and priorities, and a lack of funding.

It appears that much needs to be done by the public and private sectors with clear needs to improve planning, enhance co-operation between various levels of government and other bodies, deal with interstate rivalries and reduce fragmentation that increases costs and add inefficiencies.

It is imperative that we get this right quickly and ensure that the funds invested do in fact create value, which hitherto has not always been the case.

 

These are just a few items that we could endeavour to address to relieve our budget problem. The thought of a decade of deficits, with resultant increase in the debt load with recurring interest is not palatable, and the sooner we ditch our complacency and tell the incumbent stewards of our future to get on with growth initiatives the better it will be for the Australian society generally.Don Argus is a member of the Bank of America Global Advisory Council, chairman of the Bank of America Merrill Lynch Australia advisory board and director of the Australian Foundation Investment **Company**. He is the former chairman of BHP Billiton and Brambles, and a former chief executive of National Australia Bank.

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