FINANCIAL REVIEW

SE Companies and Markets

HD **Murray's shot across the bows**

WC 1,283 words

PD 24 November 2014

SN The Australian Financial Review

SC AFNR

ED First

PG 30

LA English

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When David Murray hands the final report of the financial system inquiry to Treasurer Joe Hockey at the end of this week, it will include a warning to all sides of politics that the government's quest to rein in the budget deficit is essential given the interconnectedness of the country's fiscal position with the stability of the financial system.

As the minor parties in the Senate fumble over support for the Coalition's attempts to rein in spending – designed to ensure general government net debt doesn't exceed about 21 per cent of GDP next year – Murray is likely to dispatch a shot across the bows of Canberra's unsteady ship, reminding legislators that the cumulative impact of failures to maintain budgetary discipline will be felt across the economy.

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The financial system inquiry's interim report observed that a strong government balance sheet is critical to safeguard the economy by ensuring foreign capital continues to fund Australia's banks and its debt.

Australia has been a net importer of foreign capital for most of its history and has therefore recorded persistent current account deficits. As Murray recognises, ongoing access to foreign funding has allowed Australia to sustain higher growth than otherwise would have been the case, and the continued inflow of foreign funding reflects the confidence foreigners have in Australia's growth prospects and its capacity and willingness to service and repay foreign liabilities.

About two-thirds of Australia's gross foreign liabilities are in the form of debt. Australia's external debt, net of liquid assets, was more than 230 per cent of current account receipts in the 2012-13 year, according to ratings agency Standard & Poor's.

Australia continues to run significant current account deficits, in excess of 10 per cent of CARs. Since the Wallis inquiry reported in 1997, household leverage has almost doubled.

Murray's final report will highlight that securing the continued faith of global capital markets to back the Australian economic story remains the most important task for the financial system.

This explains why there has been a huge focus during the year on bank capital – the reason Murray wants Australian banks to be at least as conservative, if not more so, than their international peers with regards to capital and liquidity is to ensure that the offshore investors in bank debt remain willing to continue to fund the gap between domestic deposits and the level of bank lending, which currently stands at about $600 **billion**.

In its latest report into the Commonwealth of Australia published on July 31, Standard & Poor's said Australia benefits from many fundamental strengths but "its key credit weakness is the economy's high level of external liabilities".

"The banking system in particular has a high degree of external indebtedness and remains highly reliant on the ongoing backing of foreign investors."

In recent years, as S&P points out, the current account deficit has not been funded by banks but foreign direct investment into the mining and energy sectors, and by the government sector. So the serviceability of external debt relies on the performance of exports.

In both the interim report and in several speeches this year, Murray has drawn attention to the dependence of the Australian economy on trade with China. Should demand for resources weaken sharply or US-dollar commodity prices slump, dislocations would be felt in Australia's labour and property markets. And as the interim report observed, if Australia's housing assets were to deteriorate sharply, it cannot be assumed that the foreign capital Australia requires to finance its debt will be affordable, or even accessible.

"If foreigners become reluctant to invest in Australia, the cost of funding (for both debt and equity) for Australian entities would increase significantly. The higher cost of funding would translate into lower growth in gross fixed capital formation and GDP," the interim report said.

Maintaining the confidence of foreign investors to ensure cheap access to their funding relies on Australia doing three things, according to Murray: using foreign funds productively; maintaining a prudent supervisory and regulatory regime for the broader financial system; and running a strong government balance sheet.

On the later, his interim report said sustainable fiscal settings will provide the government with greater capacity to support the financial system during a disruption, while in normal times, "the government's credit rating is reflected in private sector ratings and therefore affects the cost of and access to foreign funds for the private sector."

It is hard to predict the precise impact a sovereign ratings downgrade would have on funding costs. When the big four banks were hit with ratings downgrades in December 2011, following changes to S&P's ratings methodologies, their credit default swap spreads actually contracted by about 10 per cent, a function of prevailing market conditions at the time. But a cut to the sovereign rating may also lead to higher borrowing costs for banks, and higher interest rates across the economy.

Ratings agencies say Australia's coveted AAA credit rating and stable outlook is based on assumptions that historically conservative budgetary policies will remain in place and governments will continue to narrow the fiscal deficits and keep government debt low. In its July report, S&P said it could reduce Australia's AAA rating "if external imbalances were to grow significantly more than we currently expect, either because the terms of trade deteriorates quickly and markedly, or the banking sector's cost of external funding increases sharply. Such an external shock could lead to a protracted deterioration in the fiscal balance and the public debt burden"

For now, S&P reckons the risks associated with Australia's high private-sector external debt are manageable because of the strength of the financial system, and the strong bipartisan and community support for prudent management of public finances.

But Murray is preparing to stress in his final report that given the massive rise in leverage in the private sector over the past 20 years, the government has little headroom on debt given a big chunk of its revenue remains at the mercy of cyclical resources prices.

In an August 21 speech, Murray made a fascinating observation on this point. "To have a country which is foreign capital dependent and commodity reliant would suggest to me as a lending banker that the constraint on government debt would be at about a similar style of leverage ratio to the constraint on a large mining company, and leverage in a mining company is not significant compared to some other companies," he said.

It just so happens that the ratio of long-term debt divided by total capital for the mining sector is about 20 per cent, according to Thomson Reuters – about the same level as current net general government debt divided by GDP.

Murray said as far as he could determine, "nobody in Australia has actually put out publicly and transparently the leverage constraints on aggregate governments in Australia", meaning "there is no clear understanding that the fiscal position of the government and the prices in credit markets are directly related". This "creates an atmosphere in which the politicisation of banking and credit is far too easy, and that is not healthy," he added.

Murray is expected to highlight the distortions the tax regime has created by encouraging Australians to borrow to buy property and shares over bonds. This has lead to a highly leveraged household sector overweight property and stocks, and a banking sector overweight mortgages. These will be issues that will have to be tackled by the government's tax white paper next year.

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AN Document AFNR000020141123eabo0002u

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