Chapter 1

Background to the inquiry

Overview

1.1 A deficit in the current account on the balance of payments has become a usual part of Australia's economic landscape, deficits having been recorded for all but four of the last fifty five years.

1.2 However, there are two features of the current account deficit (CAD) in 2004-5 which are not usual - first, quarterly CAD has exceeded 7% for the first time, and second, the household sector has been the primary driver of the deficit.

1.3 The household sector has, over a period of years, moved from being a net saver to a net borrower. The government sector, which had been responsible for driving some previous CADs through large commonwealth and state budget deficits, has moved to a slightly positive or saving position. Similarly, the corporate sector, enjoying good profits, has an excess of savings over investment.

1.4 The change in the household sector's saving patterns, particularly in the last five years, has been dramatic and coincides with a large rise in household debt. Most of this debt relates to housing finance, as the country experienced a major housing boom which saw house values rise throughout the country. In the same period, credit card debt also increased by a similar order of magnitude as mortgage debt.

1.5 Borrowings by the household sector have contributed to the inflow of foreign capital associated with the CAD. As the Treasury submission to this inquiry observes:

> The household sector has been borrowing (indirectly, via the banking system) from the rest of the world to fund spending in excess of income.[1]

1.6 The household sector's appetite for imported goods is also a contributor to both household debt and the CAD. However, the picture on household debt is far from simple, as borrowings for consumption also contribute to the growth of the economy and the resulting rise in wealth and GDP.

1.7 The terms of trade are currently very favourable for Australia, and international interest rates are low. Despite these favourable conditions and repeated predictions that it would soon moderate, the CAD continued to rise and set a new record of 7.2% of GDP in the December 2004 quarter. An inquiry to explore the links between the CAD and household debt and whether there are associated issues requiring intervention was therefore timely.

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1 The Treasury, *Submission 13*, p. 6.

1.8 Views about the importance of the CAD as an economic indicator have waxed and waned over the last two decades. While controlling the level of the CAD was an objective of economic policy in the 1980s, some economists questioned that approach, particularly in an economy with a floating exchange rate with its in-built self-correcting mechanisms. Further, past attempts to control the CAD through monetary policy resulted in recession and widespread economic hardship.

1.9 The view that governments should not attempt to control the CAD, most notably advanced by the Australian National University's Professor John Pitchford, eventually prevailed. This view was adopted widely, including by the Treasury. The current conventional wisdom appears to be that the CAD is not of major significance unless it points to underlying structural problems in an economy.

1.10 Countries can derive positive benefits from a CAD. Running a deficit and an accompanying capital account surplus provides the means for the efficient movement of capital to where it is most needed. For example, the inflow of capital enables Australia to develop industries and resources which it could not achieve with its own financial resources. Such developments, in turn, provide employment opportunities and export income.

1.11 Nonetheless, when Australia's deficit reached 7.2 per cent in the December 2004 quarter some economic commentators warned that perhaps all was not well. Does a current account deficit that has exceeded 7 per cent of GDP indicate that there are structural problems in the economy? Should policy makers be concerned about that level of CAD and what could they do about it? Should they be concerned about the rise of household debt which has driven the CAD? What risks if any do high CADs and debt levels pose for households and the economy? These are the main themes of this inquiry.

Report Structure

1.12 This report is organised into five chapters and three major appendices.

1.13 Chapter 2 provides factual background on the CAD. Two key ways of looking at deficits are examined, from a trade perspective and from a savings/investment perspective, the method favoured by the Treasury. The chapter also looks at the impact of the CAD on foreign liabilities and at the international experience.

1.14 Chapter 3 explores at some length a number of key issues in relation to Australia's CAD, commencing with a discussion of what has been driving the CAD.

1.15 Chapter 4 focuses on the main underlying cause of the CAD, household debt. The chapter looks at the growth of household debt, how it is distributed across households, and how well households are coping with it.

1.16 The final chapter examines lending practices of financial institutions, with particular emphasis on the slippage in lending standards that has taken place as lenders chase market share.

1.17 The report also contains three significant appendices. Appendix 3 looks at the relationship between the CAD and foreign liabilities. Appendix 4 provides a summation of views on the CAD of six professional economists who participated in a Round Table forum with the Committee on this subject on 15 August 2005. Appendix 5 provides some analysis of factors contributing to the increases in household debt of the last decade, including the house price boom.

Conduct of the inquiry

1.18 This inquiry was referred to the Committee by the Senate on 9 December 2004. Following its referral, the inquiry was advertised nationally, and notified on the Committee's website. The Committee also sent out notifications of the inquiry to a wide range of groups who might have been expected to have an interest.

1.19 A total of eighteen submissions were received over an extended period. A list of submissions is attached at Appendix 1. The Committee was puzzled at the relatively low number of submissions which were received. A possible reason presented itself as the inquiry progressed. It became evident that the three principal parts of the topic could each justify inquiries in their own right - household debt; imports of consumption goods (in the overall context of Australia's balance of trade); and the current account. The Committee recognises that it may have been ambitious in trying to combine these three major subject areas into a single inquiry.

1.20 The Committee conducted two public hearings, one in Sydney (which focused on the issue of household debt) and the second in Canberra (which focused on the current account deficit). The second hearing was conducted in round table format and involved a small number of prominent economists, several of whom had not made formal submissions to the inquiry. The witnesses who gave evidence are listed at Appendix 2.

1.21 Perhaps because of the wide-ranging nature of the topic, only a small minority of submissions comprehensively addressed the terms of reference. Several groups interpreted the terms of reference for their own purposes, and put forward evidence on the household debt issue from a different perspective to that originally envisaged. The issues raised in several of these submissions focused on problem household debt, that is, those households who were unable to manage their debt levels and were experiencing hardship as a result. It should be noted that at present, this group represents only a very small subgroup of the population.

1.22 Some submissions, most notably the submissions from Dun and Bradstreet and MasterCard, also used the inquiry to advance arguments for the introduction of positive credit reporting, which would represent a significant change to Australia's credit assessment procedures. Proponents argued that Australia is one of the few countries that still use a negative credit reporting system and contended that significant economic benefits could result from a change to positive credit reporting.

1.23 While this issue (and the issue of problem household debt generally) was not the intended focus of the inquiry, in fairness to those who took the trouble to make submissions the Committee elected to address them in the report.

1.24 The Committee thanks all those who contributed to the inquiry.

1.25 The Committee also particularly wishes to acknowledge the assistance and advice provided during the inquiry by the following individuals:

> Mr John Hawkins, Manager, Domestic Economy Division, Department of the Treasury;
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> Mr Tony Kryger, Statistics Group, Department of Parliamentary Services;
>
> Ms Jane Nash, Head of Government and Regulatory Affairs, ANZ Banking Group;
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> Mr Anthony Pearson, Head of Australian Economics, ANZ Banking Group; and
>
> Mr David Richardson, Economics Group, Department of Parliamentary Services.
>
> Mr George Stanwix, Domestic Economy Division, Macroeconomic Group, Department of the Treasury