The Senate

# Economics References Committee

## Consenting adults deficits and household debt

Links between Australia's current account deficit, the demand for imported goods and household debt

October 2005

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# GLOSSARY

Sources: Australian Bureau of Statistics, Cat. 1360.0, Cat. 5206.0 and Cat. 5331.0; Parliamentary Library Monthly Economic and Social Indicators (MESI); Reserve Bank of Australia Bulletin.

**Average weekly earnings**
Average gross (before tax) earnings of employees. Average weekly earning statistics do not relate to average award rates or to the earnings of the 'average' person.

**Banks' housing loan interest rate**
Standard variable rate for housing loans by large banks.

**Banks' prime interest rate**
Predominant or representative indicator rate on variable rate business loans, i.e. overdrafts and fully drawn loans, of major banks.

**Business investment**
Private gross fixed capital expenditure (i.e. expenditure by private firms on goods and services used in the production process without any deduction for depreciation) on non-dwelling construction and equipment.

**Current account**
The current account indicates whether a country has absorbed more goods and services and income than it has produced. It is the difference between receipts and payments as the result of transactions in goods, services, income and current transfers between Australia and the rest of the world. A current account deficit means that total payments exceed total receipts, while a current account surplus means the reverse. The trade balance is the difference between the total credit (export) value and the total debit (import) value of goods and services. The net income balance is the difference between the value of income (such as interest, dividends and reinvested earnings) earned by residents from non-residents (credits) and income earned by non-residents from residents (debits). Net current transfers are the difference between current transfer credits and debits (for example, Australian foreign aid is a debit, while pensions paid to Australian residents by foreign governments is a credit).

**Consumer price index**
An index which measures changes in the price of a basket of goods and services from a base period. Changes in the Consumer Price Index are the most commonly used measure of inflation.

**Consenting-adults deficit**
The expression 'consenting-adults deficit' commonly describes a deficit which is made up of largely private sector debt and the foreign lenders who are providing the money seem to be quite willing to lend as much as is required.

**Foreign debt**
Gross foreign debt is all non-equity financial claims by non-residents on residents of Australia. The major component of gross foreign debt is the amount of borrowings from non-residents by residents of Australia. Neet foreign debt is gross foreign debt less non-equity assets such as foreign reserves held by the Reserve Bank and lending by residents of Australia to non-residents.

**Foreign liabilities or international investment position**
Net foreign liabilities is defined as Australia's gross foreign liabilities less gross foreign assets. This is sometimes referred to as the 'Net international investment position' or 'Net foreign investment'.

**Gross domestic product**
The total market value of goods and services produced after deducting the cost of goods and services used up in the process of production (intermediate consumption) but before deducting consumption of fixed capital (depreciation). It is equivalent to gross national expenditure plus exports of goods and services less imports of goods and services.

**Household saving ratio**
The ratio of household net saving to household net disposable income. Household net saving is calculated as household net disposable income less household final consumption expenditure. Household net disposable income is calculated as household gross disposable income less household consumption of fixed capital.

**Home loan affordability indicator**
The home loan affordability indicator measures the relationship between median weekly family income and average monthly home repayments on new loans.

**Household saving ratio**
Household saving (household disposable income less household expenditure on goods and services not used for further production) as a percentage of household disposable income (household income less taxes, fees, fines, etc).

**National saving**
Calculated as the sum of the net saving of each of the resident sectors – households and unincorporated enterprises, non-financial corporations, financial corporations and general government. Also referred to as net saving.

**Reinvested earnings and undistributed branch profits**
Reinvested earnings and undistributed branch profits refer to that part of the undistributed income of a direct investment enterprise that is attributable to direct investors in the enterprise. Undistributed income attributable to direct investors is included as investment income in the current account, with a corresponding offsetting entry in the financial account.

**Seasonally adjusted estimates**
Estimates in which the element of variability due to seasonal influences has been removed. Seasonal influences are those which recur regularly once or more a year.

**Terms of trade**
The relationship between the prices of exports and the prices of imports. The usual method of calculating the terms of trade is by dividing the implicit price deflator for exports by the implicit price deflator for imports.

# RECOMMENDATIONS

## Recommendation 1

**The Committee recommends that Treasury undertakes more analysis related to the longer-term outlook for the current account, and publishes its findings to enhance public understanding and discussion.**

## Recommendation 2

**The Committee recommends the Government develop new strategies to promote the export of Elaborately Transformed Manufactures and services to underpin a long term improvement in the balance of trade.**

## Recommendation 3

**The Committee recommends that the Government introduces policies designed to bring about an improvement in the medium-to-long term average of the current account deficit, including improving domestic savings and increasing the diversity and international competitiveness of the export sector.**

## Recommendation 4

**The Committee recommends that the Government reassess its decision to reject the recommendation of the Productivity Commission for a review of those aspects of the personal tax regime that have recently contributed to excessive investment in rental housing.**

## Recommendation 5

**The Committee recommends that through the Ministerial Council on Consumer Affairs, the State and Territory Governments develop and pass uniform legislation for the development of educational material focussed on the risks associated with investing in real estate, borrowing against home equity, and of borrowing at debt-to-equity ratios in excess of 80 per cent; and that real estate agents be required to provide copies of this material to prospective buyers at the point of first enquiry.**

## Recommendation 6

**The Committee recommends that the feasibility of deeming a broker to be the agent of the lender be further investigated as a possible method of addressing the slippage in lending practices that has entered the financial services industry.**

## Recommendation 7

**The Committee recommends that the States and Northern Territory develop and pass uniform consumer credit legislation requiring credit providers to undertake appropriate checks of borrowers' capacity to pay before issuing new credit cards or raising credit limits. The ACT Fair Trading Act provides an appropriate model for this legislation.**

## Recommendation 8

**The Committee recommends that the Consumer Credit Code be amended to mandate the provision, in a clear and easily understood manner, of a summary of the interest rates, key fees and core terms and conditions of card interest rates in all credit card promotional literature. This requirement is also to apply to charge cards and interest free periods offered by retailers.**

# 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.

---

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;
>
> Mr Tony Kryger, Statistics Group, Department of Parliamentary Services;
>
> Ms Jane Nash, Head of Government and Regulatory Affairs, ANZ Banking Group;
>
> 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

# Chapter 2

## Background to Australia's current account

*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]

### What is the current account?

2.1 Put simply, the current account indicates whether a country has absorbed more goods and services and income than has it produced.[2] A current account deficit means that total payments exceed total receipts, while a current account surplus means the reverse.

2.2 Another way of looking at the current account is through savings and investment. If a country's balance on current account is in deficit, then national investment exceeds national saving and the country is a net recipient of investment funds from the rest of the world.

2.3 A current account deficit (CAD) is financed by borrowing from overseas and/or by foreign equity investments in Australia.

### Australia's current account[3]

2.4 Since 1950, Australia has had a surplus on its current account in only four years: 1950-1, 1952-3, 1956-7, and 1972-3. The other years all recorded current account deficits.[4]

2.5 The annual balance on current account from 1959-60 to 2004-05 is shown in Table 2.1. In 2004-05 the balance on the current account was in deficit by $57.2 billion.

---

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

2 The ABS defines the balance on current account as the sum of the balances on goods trade, services trade, income and current transfers. *Measuring Australia's Economy*, ABS cat. 1360.0. See also Footnote 6.

3 This description of Australia's current account is largely based on the submission from the Department of the Treasury (Submission 13). The Treasury was helpful in providing the Committee with updated versions of the graphs contained in its submission so that this report could reflect the latest available figures.

4 The Treasury submission states that since European settlement Australia has had current account deficits in 9 out of every 10 years (Submission 13, p. 1), but Australia has had only 4 current account surpluses since 1950, the most recent in 1972-3.

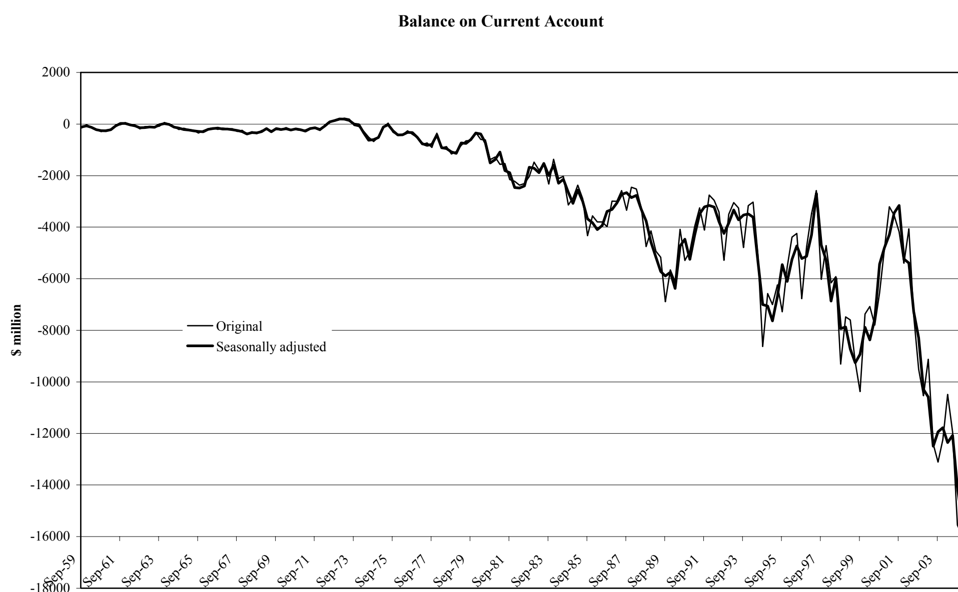
**Table 2.1: Balance on current account, original, $billion[5]**

| Year | Balance on current account, $b | Year | Balance on current account, $b |
|---|---|---|---|
| 1959-60 | -0.5 | 1984-85 | -11.3 |
| 1964-65 | -0.8 | 1989-90 | -22.7 |
| 1969-70 | -0.8 | 1994-95 | -28.4 |
| 1974-75 | -1.3 | 1999-2000 | -32.6 |
| 1979-80 | -2.2 | 2004-05 | -57.2 |

Source: ABS, *Balance of Payments and International Investment Position* (Cat. 5302.0)

2.6 Figure 2.1 shows the movement in the balance on current account on a quarterly basis since the September 1959 quarter, in value terms. Both original and seasonally adjusted figures are shown. Table 2.1 shows the annual results, while Figure 2.1 graphs the quarterly movements.

**Figure 2.1: Australia's balance on current account, quarterly (September 1959 quarter to June 2005 quarter), $m, original and seasonally adjusted**



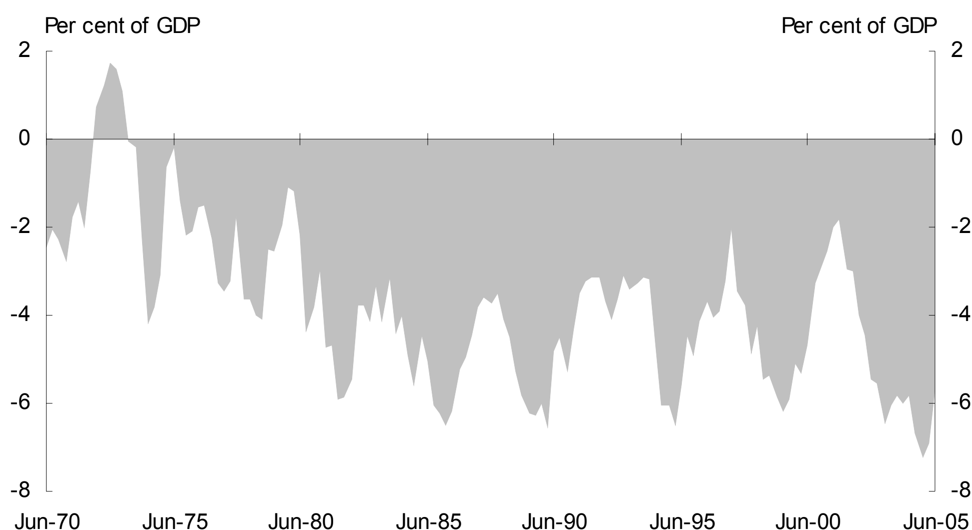

Source: ABS, *Balance of Payments and International Investment Position* (Cat. 5302.0)

5 Unless otherwise stated, values in this report are expressed in A$ billions. $1 billion = 1000 x $1 million. The figures have generally been rounded to one decimal place.

2.7 The current account is often expressed as a percentage of Gross Domestic Product (GDP) to put its economic significance into context. The CAD fluctuated between 2 and 3 per cent of GDP in the 1960s and 1970s and between 4 and 6 per cent of GDP in the 1980s and 1990s. It has been over 5 per cent for the last 11 quarters (i.e. since the June 2003 quarter).

2.8 Australia's balance on current account as a percentage of GDP since 1970 is shown in Figure 2.2. Over that period Australia has recorded a deficit in every year except 1972-3.

**Figure 2.2: Current account balance as a percentage of GDP, quarterly**




Source: Australian Bureau of Statistics (ABS) catalogue no. 5302.0 and 5206.0.

2.9 Treasury's submission to the Inquiry explains that there are two ways of looking at the current account - from a trade perspective and from a savings/investment perspective.[6]

### *The current account from a trade perspective*

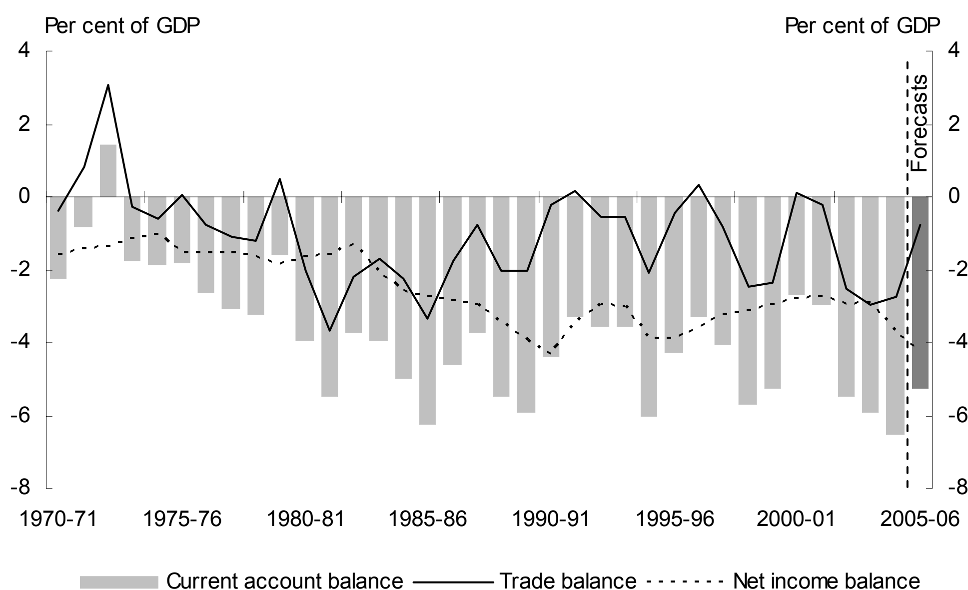
2.10 From a trade perspective, a country's current account is the sum of its trade balance (exports of goods and services less imports of goods and services) and its

6 The Treasury, *Submission 13*, p.4.

income balance (interest payments and dividends received less paid) and current transfers.[7]

2.11 Figure 2.3 shows that the deficit in the income balance (the broken line in the graph) has usually been bigger than the deficit in the trade balance (continuous line) thus contributing more towards the overall deficit in the current account. However, most of the fluctuation in the current account has been as a result of fluctuations in the trade balance, as the net income deficit has been relatively stable, or slowly declining, since its sharp run up in the mid-1980s.[8]

**Figure 2.3: Current account balance as a per cent of GDP, year average**




Source: Australian Bureau of Statistics cat. no. 5302.0 and 5206.0, and Treasury.

## *Australia's trade balance*

2.12 Australia has generally run a deficit in its balance of trade - that is, it tends to import more goods and services than it exports. Figure 2.4 shows that the gap between imports and exports has usually been relatively small. However, the value of exports of goods and services has exceeded the value of imports of goods and services in only 6 years since 1970.

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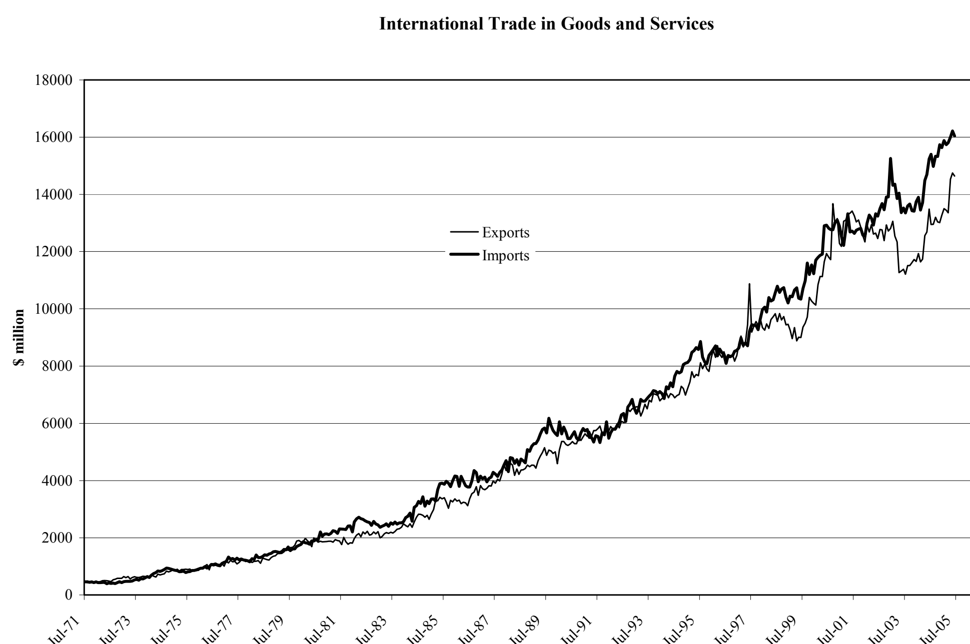
[7] The trade balance is the difference between the total credit (export) value and the total debit (import) value of goods and services. The net income balance is the difference between the value of income (such as interest and dividends) earned by residents from non-residents (credits) and income earned by non-residents from residents (debits). Net current transfers are the difference between current transfer credits and debits (for example, Australian foreign aid is a debit, while pensions paid to Australian residents by foreign governments is a credit). These definitions are from *Measuring Australia's Economy*, ABS cat. 1360.0.

[8] The Treasury, *Submission 13*, p. 2.

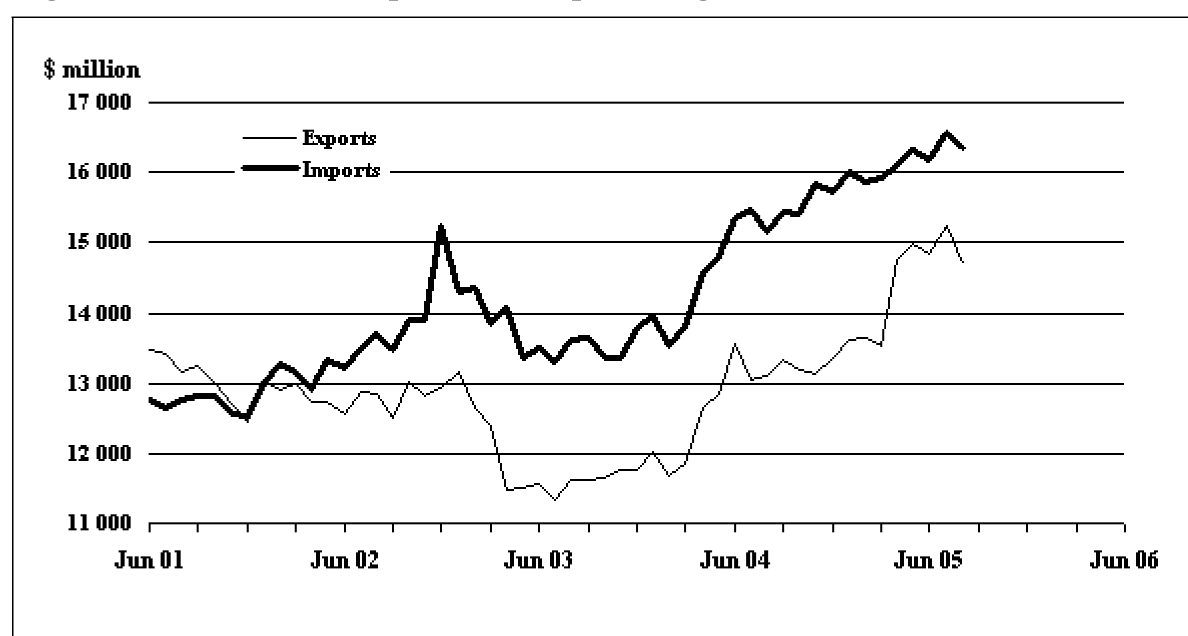
**Figure 2.4: Australian imports and exports of goods and services, 1971 - 2005**




Source: ABS, *International Trade in Goods and Services* (Cat. No. 5368.0). Monthly figures are seasonally adjusted.

2.13 Small balance of trade surpluses were achieved in 1996-97 and again in 2000-01, but then significant trade deficits were recorded in 2002-03, 2003-04 and 2004-05. Figure 2.5 shows these changes on an enlarged scale for the period June 2001 to June 2005. The trade deficit narrowed slightly in the June 2005 quarter as higher export prices for minerals and energy took effect and exports grew faster than imports, but then widened again in August 2005, when exports slowed more than imports.

**Figure 2.5: Australian imports and exports of goods and services, 2001 - 2005**




Source: ABS, *International Trade in Goods and Services* (5368.0)

2.14 Predictions are that export volumes of minerals and energy commodities are beginning to pick up, as infrastructure constraints are eased. The combination of high export prices and higher export volumes should result in the gap between exports and imports closing over the next few months.

2.15 The Treasury submission notes that the trade balance tends to move with the economic cycle. When domestic demand grows faster in Australia than in the rest of the world, import volumes tend to rise more than export volumes and so the trade deficit becomes larger (as has happened recently). During the recession of the early 1990s (and the slowdown around 2000), import volumes were more subdued and the trade deficit was correspondingly smaller.[9]

### *Australia's income balance*

2.16 The income balance shows the annual cost of servicing Australia's net foreign liabilities. The change over the last 20 years in Australia's net foreign liabilities is shown in Table 2.2.

**Table 2.2: Australia's net foreign liabilities[10], current prices, $billion**

| As at 30 June | Net foreign debt (borrowing), $b | Net equity liabilities, $b | Total net foreign liabilities, $b |
|---|---|---|---|
| 1985 | -53.1 | -25.9 | -78.9 |
| 1990 | -130.8 | -42.0 | -172.8 |
| 1995 | -190.8 | -64.7 | -255.5 |
| 2000 | -272.6 | -56.1 | -328.8 |
| 2005 | -430.0 | -86.9 | -516.8 |

Source: RBA monthly bulletin, *Table H5 Australia's net foreign liabilities*

2.17 Since 1950 Australia has always had deficits in its income balance - that is, Australia has paid more in interest payments and dividends on foreign borrowings and foreign investment in Australia than it has received from money Australia has lent and invested overseas.

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9 The Treasury, *Submission 13*, p. 2.

10 'Net foreign liabilities' is defined as Australia's gross foreign liabilities less gross foreign assets. This is also referred to as the 'Net international investment position'. RBA Bulletin, Notes to Table H5.

2.18 The main components of the income balance are payment of interest on foreign debt (borrowings) and payments of dividends and reinvested earnings on equity investments. These are shown in Table 2.3.

**Table 2.3: Major components of Australia's income balance at current prices, 1999-00 to 2004-05, $billion[11]**

| Year | Net interest payments | % of total | Other net income payments[12] | % of total | Total net income payments | Total % |
|---|---|---|---|---|---|---|
| 1999-00 | -13.4 | 74% | -4.8 | 26% | -18.3 | 100% |
| 2000-01 | -14.6 | 78% | -4.1 | 22% | -18.7 | 100% |
| 2001-02 | -13.6 | 70% | -5.7 | 30% | -19.3 | 100% |
| 2001-03 | -11.6 | 54% | -9.9 | 46% | -21.5 | 100% |
| 2003-04 | -12.5 | 53% | -11.2 | 47% | -23.7 | 100% |
| 2004-05 | -15.4 | 49% | -15.8 | 51% | -31.2 | 100% |

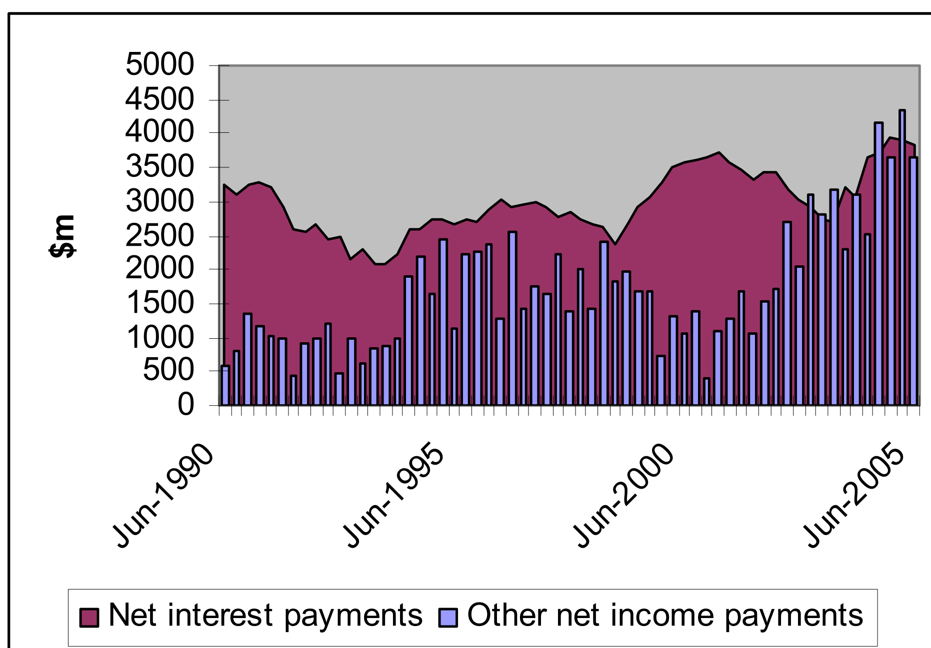
Source: RBA Monthly Bulletin, *Table H7 Australia's service payments on net foreign liabilities*

2.19 Figure 2.6 shows how the major components of the income balance 'net interest payments' and 'other net income payments' have changed since 1990, on a quarterly basis.

[11] Current transfers are not included in this table. Net current transfers totalled -$420m in 2004 - 05. ABS, *Balance of Payments* (Catalogue 5302.0, June quarter 2005).

[12] 'Other net income payments' includes all non-interest income items such as dividends, reinvested earnings, and charges on accounts payable and receivable. RBA Bulletin, Notes to Table H7.

**Figure 2.6: 'Net interest payments' and 'Other net income payments', quarterly changes, $m**




Source: RBA *Monthly Bulletin,* Table H7

2.20 Until recently the 'Other net income payments' component of the income balance (shown as bars in Figure 2.6) was less significant than the 'Net interest payment' component within the total income balance. However, as Figure 2.6 shows that is changing with both components now representing about 50% each of the total. Changes in the income balance are discussed in more detail in Chapter 3 (paras 3.49 to 3.68).

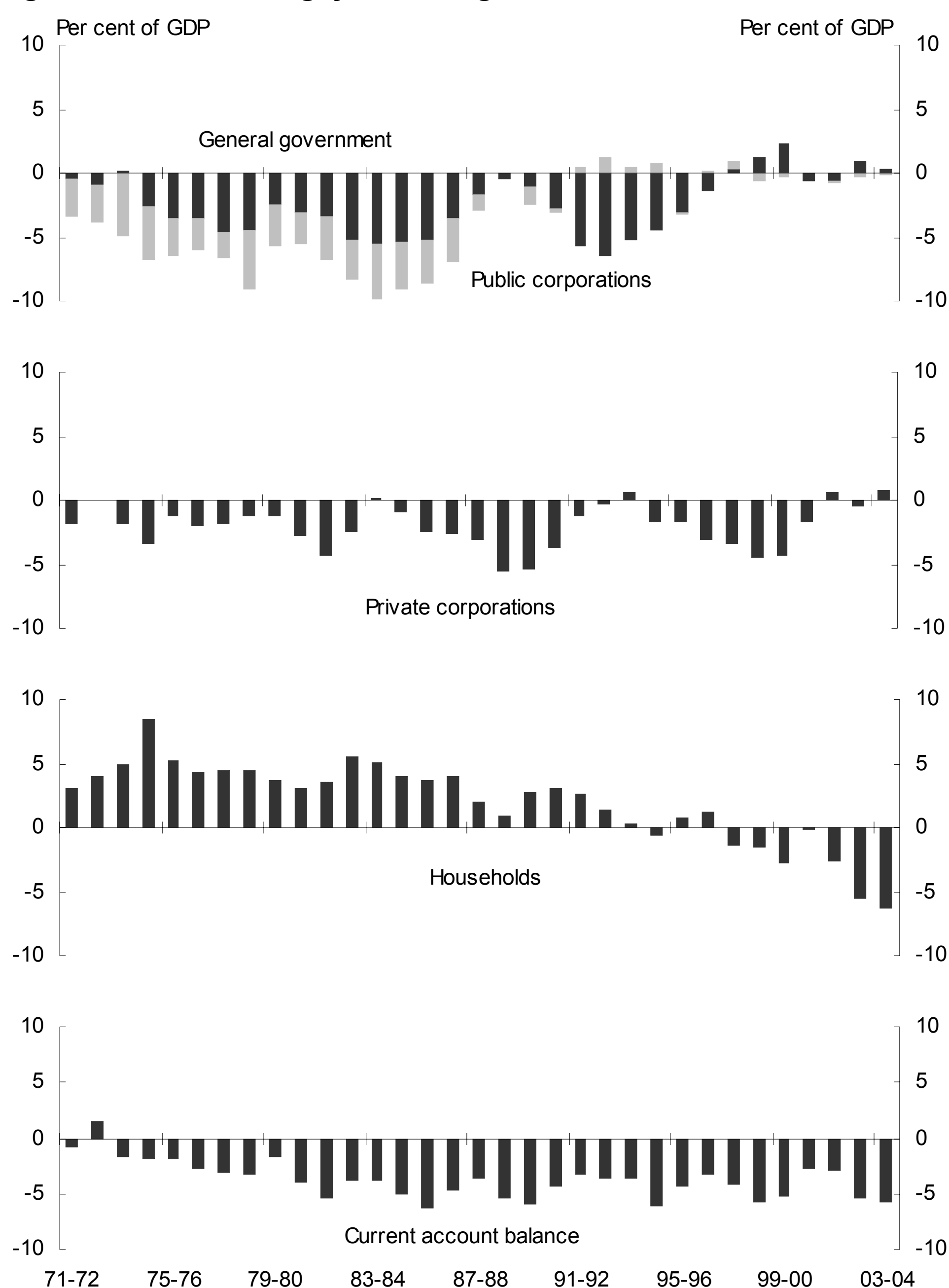
***The current account from a savings/investment perspective***

2.21 The Treasury submission explains that while the CAD is most commonly discussed from a trade perspective, it is best understood within a saving/investment framework. [13] This is illustrated in Figure 2.7.

2.22 The first three panels of Figure 2.7 show ‘net lending’ (when saving exceeds investment) or ‘net borrowing’ (when saving falls short of investment) by government, corporations and households in Australia. The final panel is the current account balance (which can be thought of as ‘net borrowing’ by Australia from the rest of the world). The numbers in first three panels add up to the current account balance shown in the final panel.

[13] The Treasury, *Submission 13*, p. 4.

**Figure 2.7: Net lending, year average**




Source: Australian Bureau of Statistics cat. no. 5204.0, 5302.0 and Treasury (original data).

2.23 Figure 2.7 shows that for most of the period since 1970 the public (or official or government) sector (panel 1) was a net borrower, but it has now become a small net lender - that is, the public sector is in overall budget surplus.

2.24 The private sector is made up of private corporations and households. Panel 2 in Figure 2.7 shows that while private corporations have traditionally been borrowers, in recent years they have become net lenders as high profits exceed investment. In contrast, households (panel 3) have traditionally been net lenders (due to strong savings) but in recent years they have become net borrowers. Households have been

borrowing (indirectly, via the banking system) from the rest of the world to fund spending in excess of income.[14]

2.25 Over the past 15 years the household sector has changed progressively from being a net lender to the rest of the economy to being a net borrower. This reflects both an increase in household investment and a fall in household saving (see Chapters 4 and 5 for a detailed discussion of household debt in Australia).

2.26 The graphs in Figure 2.7 show that, from a savings/investment perspective, since about 2000-01 Australian household spending/debt has been the principal contributor to the current account deficit.

## How does the CAD impact on net foreign liabilities?

2.27 Australia has nearly always had a deficit on its current account, although it wasn't until the 1980s that these deficits were associated with a build up of foreign debt (borrowings). Earlier deficits were relatively small and the capital inflow to finance those deficits was largely in the form of long-term equity investment. However, from the early 1980s the size of the average CAD almost doubled, to 4.4 per cent of GDP, over the next 20 years.[15] Almost all the capital inflow which financed these higher deficits was in the form of overseas borrowings rather than equity.

2.28 While current account deficits contribute to a nation's net foreign liabilities, the CAD for a given period does not necessarily equal the change in net foreign liabilities that occurred over that period. For example, in 2004-05 the current account deficit totalled $57 billion, but net foreign debt (borrowings) increased by $35 billion and net foreign equity increased by $11 billion, giving a total increase in net foreign liabilities of $46 billion over that 12 months.

2.29 The relationship between the CAD and net foreign liabilities is quite complex. A detailed explanation is provided in Appendix 3.

## How does Australia's current account compare with other countries?

2.30 In 2004, of the 30 countries included in the bulletins of the Organisation for Economic Cooperation and Development (OECD), thirteen had current account surpluses and seventeen had deficits. The overall average for the OECD was a deficit of 1.2% of GDP.[16]

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

15 See Figure 2 in Chapter 3 for details.

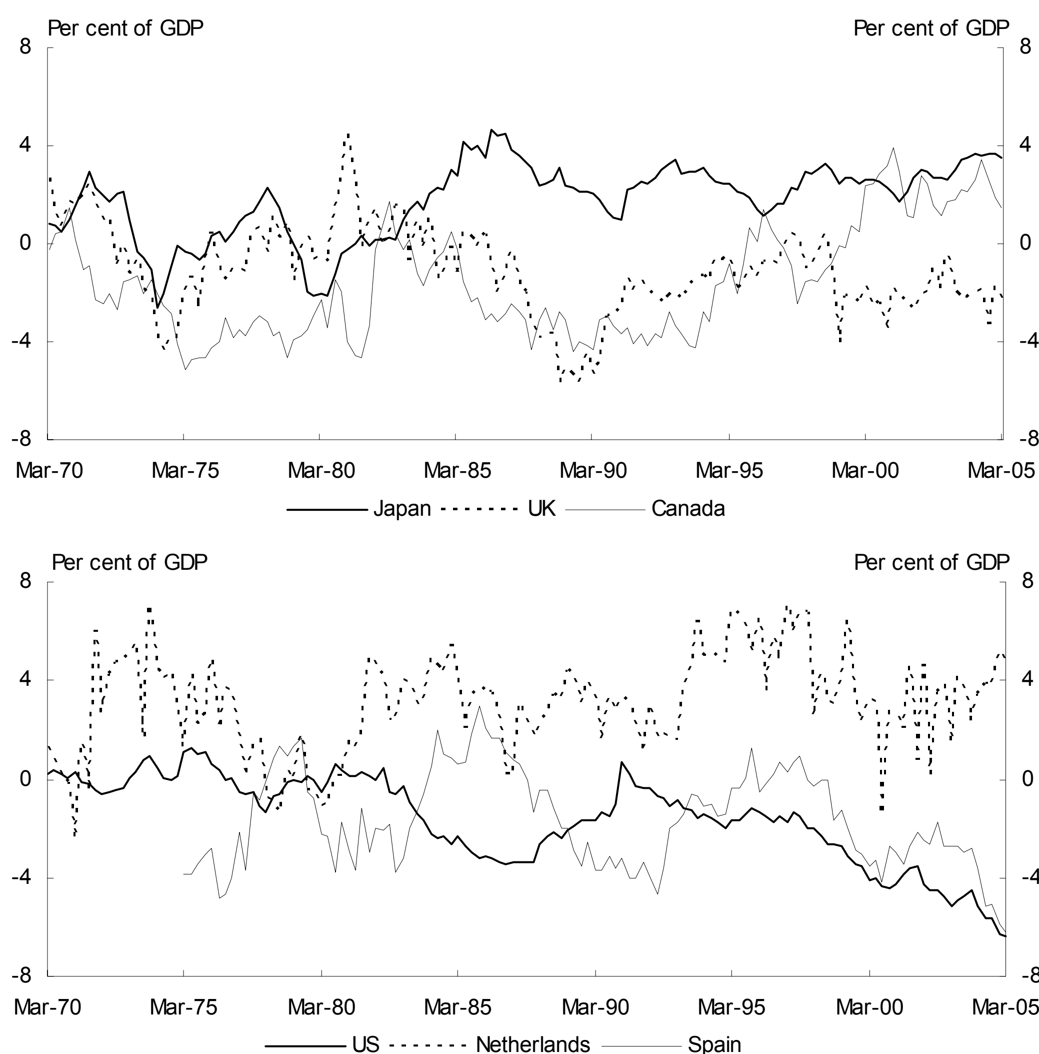
16 OECD, *Economic Outlook*, No. 77, June 2005.

2.31 Of the countries with surpluses, only Austria (0.3%) had a current account surplus of less than 2.6%. The highest surpluses were recorded by Sweden (8.0%), Luxembourg (8.8%), Switzerland (12.0%) and Norway (13.8%).

2.32 Of the countries with a current account deficit, the lowest was France (0.3%) and the highest were Australia and New Zealand (both 6.3%), Portugal (7.8%), Iceland (8.1%), and Hungary (9.4%).

2.33 Figure 2.8 (below) shows the movement in the current account as a percentage of GDP of six OECD countries since 1970: Japan, UK and Canada are shown in the first panel, and the USA, the Netherlands and Spain in the second panel.

**Figure 2.8: Current account balance as a per cent of GDP, quarterly, selected countries**




Source: OECD *Economic Outlook Bulletin*

2.34 The graphs suggest that the early 1980s were a turning point for several countries. Since then, the USA, UK and Spain have experienced mainly deficits in their current accounts while Japan commenced a period of sustained surpluses. That was also the time that Australia's average CAD stepped up to a new level (see Figure 3.2).

2.35 Canada has had an interesting experience with its current account. After recording a number of relatively high current account deficits in the 1970s and 1980s, in 1994 the size of the deficits started shrinking and Canada has recorded current account surpluses since 1999.

2.36 Given the similarities between Australia and Canada, the Committee feels that there may be salient lessons to be learnt from Canada's experience.

# Chapter 3

# Australia's current account – key issues

*At some point, net external liabilities to GDP have to stop rising. They cannot go on going up forever, but it is far from obvious how much further net external liabilities to GDP could rise.*[1]

## Background

3.1 This section of the report explores a number of key issues relating to Australia's current account which were raised in submissions to the Inquiry, and discussed during the Round Table held in Canberra on 15 August 2005.

3.2 The economists who participated in the Round Table were:

- Professor Ross Garnaut, Professor of Economics, Division of Economics, Research School of Pacific and Asian Studies, Australian National University;
- Dr David Gruen, Chief Adviser (Domestic), Macroeconomic Group, Department of the Treasury;
- Mr John Hawkins, Manager, Domestic Economy Division, Department of the Treasury;
- Mr Anthony Pearson, Head of Australian Economics, ANZ Banking Group;
- Mr Michael Potter, Director of Economics and Taxation, Australian Chamber of Commerce and Industry; and
- Dr Richard Simes, Vice President, CRA International (appearing in a private capacity).

3.3 Evidence presented by Mr Pat Conroy, National Projects Officer of the Australian Manufacturing Workers Union (AMWU) at the public hearing in Sydney on 16 May 2005 was also considered in the context of this chapter.

3.4 At the conclusion of the Round Table, the Chair invited each participant to make concluding remarks. The concluding remarks are set out in full in Appendix 4 to this report, as they are a good summation of the views expressed.

3.5 The key issues which were considered during the Inquiry are expressed as a series of questions in this chapter.

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1 Dr David Gruen, Department of the Treasury, *Proof Committee Hansard*, 15 August 2005, p. E2.

## What has been driving the Current Account Deficit?

3.6 There was general agreement in the evidence received by the Committee that the household sector has been the main driver behind the Current Account Deficit (CAD) in recent years.[2]

3.7 Professor Garnaut expressed it this way:

> The biggest single cause of a large current account deficit is the decline in household savings, which I think most economists … would attribute above all else, directly and indirectly, to the extraordinary wealth effects of our housing boom, which is large by our historical standards and large by world standards. It led Australian households … to think that they were very wealthy and very comfortable, and that they could comfortably go through a period of higher consumption expenditure and low, zero or negative savings …[3]

3.8 Dr Gruen also believes that the present CAD is attributable to the household sector. He said:

> In the last 25 years it is only in the last couple of years that the household sector has run a savings-investment imbalance of the order of the size of the current account. I think it is reasonable from that perspective to say that it is the household sector where, if you like, you can explain why the current account has been as large as it has recently. I think it is reasonable to say that that is largely a consequence of savings-investments decisions by the household sector.[4]

3.9 Likewise, Mr Conroy identified households as the driver of economic growth in recent years:

> The growth in household debt has been the driver of Australia's economic growth over the last eight years and in particular the last two years.[5]

3.10 But Mr Pearson said that he preferred to look at the CAD from a trade perspective. He attributes the present high CAD to an 'acceleration of import growth since 2001, particularly in volume terms, but in particular there has been flatness in the volume of exports'. That meant a widening trade deficit which fed into a high

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2 See also the discussion on the saving/investment perspective of the current account in paras 2.21 to 2.26 in Chapter 2.

3 *Proof Committee Hansard*, 15 August 2005, p. E4.

4 *Proof Committee Hansard*, 15 August 2005, p. E8.

5 *Official Committee Hansard*, 16 May 2005, p. E13.

CAD. However, he considered that the breaking of the drought would lift agricultural exports and higher prices for minerals and energy can also be expected to lift exports.[6]

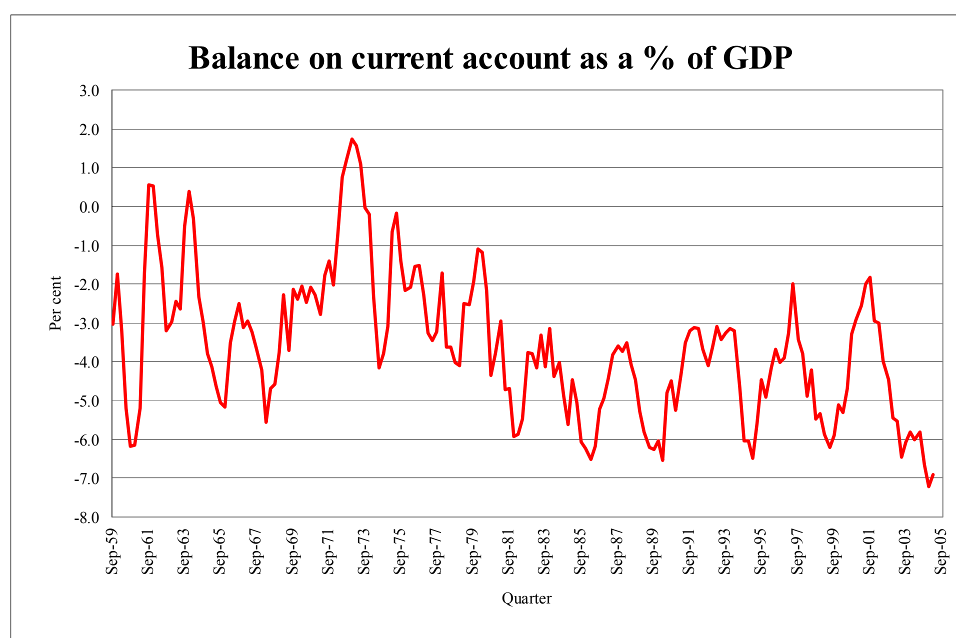
***What is the outlook for Australia's current account?***

3.11 At the Round Table discussion Dr Simes expressed the view that the average of the CAD is moving up to a new and higher level. He said:

> My assessment of the numbers is that, after some of the things in the system work their way through, we are probably looking at the average of the current account deficit to GDP increasing from around 4½ per cent to maybe between five and six per cent.[7]

3.12 Figure 3.1 shows the wide fluctuations over the last 45 years in the balance of the current account when expressed as a percentage of GDP. As discussed in Chapter 2, the current account has been in continuous deficit since 1973 and the deficits appear to be increasing in size, both in dollar terms and as a percentage of GDP.[8]

**Figure 3.1: Balance on current account as a percentage of GDP**




Sources: ABS, *Balance of Payments and International Investment Position* (Cat. No. 5302.0) and *National Income Expenditure and Product* (Cat. No. 5206.0)

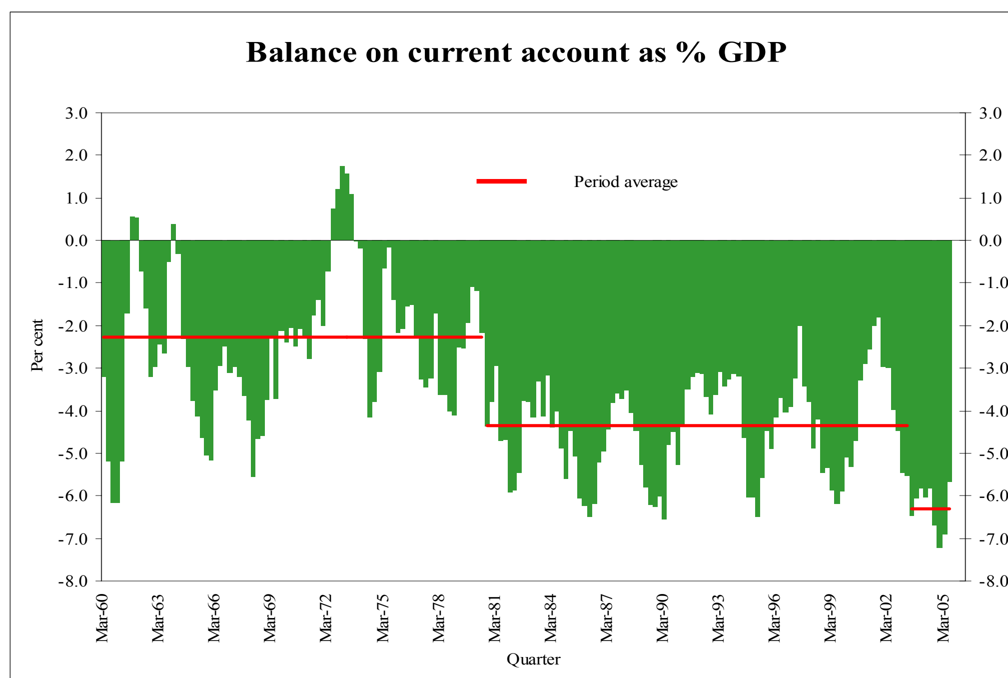
6 *Proof Committee Hansard*, 15 August 2005, p. E6.

7 *Proof Committee Hansard*, 15 August 2005, p. E6.

8 See Table 1 and Figures 1 & 2 in Chapter 2.

3.13 A way of looking for trends is to identify if there have been periods which have involved a quantum shift. Figure 3.2 suggests that since 1960 the CAD has experienced two periods involving quantum shifts, with a possible third period starting in 2003.

**Figure 3.2: Balance on current account as a percentage of GDP, showing period averages**




Source: ABS, *Balance of Payments and International Investment Position* (Cat. No. 5302.0) and ABS, *National Income Expenditure and Product* (Cat. No. 5206.0). Bars show quarterly results based on original figures.

3.14 Figure 3.2 shows that in the period 1960 - 1980 the CAD averaged 2.4 per cent of GDP. There was a quantum shift to a new level for the period 1981 - 2002, during which the CAD averaged 4.4 per cent of GDP. Figure 3.2 speculates that in 2003 Australia may have taken another quantum step up, to a period when the CAD could average around 6 per cent of GDP per annum.

3.15 During the second 'step' period shown in Figure 3.2 (1981 - 2002) the quarterly CAD was less than the average of the previous period in only two quarters - in the June 2001 quarter (2.0 per cent), and in the September 2001 quarter (1.8 per cent). All the other quarters in the second period recorded current account deficits which were above the 2.4 per cent average for the 1960 - 1980 period.

3.16 There have been several periods since 1960 during which the CAD has exceeded 5 per cent for more than three consecutive quarters. These periods were:

**Table 3.1: Periods of consecutive quarters when the CAD exceeded 5% of GDP.**

| Period | Number of consecutive quarters the CAD exceeded 5% of GDP |
|---|---|
| June 1960 – March 1961 | 4 |
| December 1981 – June 1982 | 3 |
| June 1985 - September 1986 | 6 |
| December 1988 - March 1990 | 6 |
| September 1994 – June 1995 | 4 |
| September 1998 - March 2000 | 7 |
| December 2002 – present (June 2005) | 11 |

Source: ABS, *Balance of Payments and International Investment Position* (Cat. No. 5302.0)

3.17 These periods of high CAD appear to be occurring more frequently and for longer.

3.18 The CAD of 5.7 per cent in the June 2005 quarter means that the CAD has now been over 5 per cent of GDP for eleven consecutive quarters (including the new record of 7.2 per cent set in the December 2004 quarter). The average of the CAD for the last 11 quarters was about 6 per cent.[9]

3.19 Mr Conroy opined that the recent current account deficits would have been higher except for the record terms of trade. He said:

> The only reason that the 2004 and 2005 current account deficits have not attracted as much concern as the ones in the mid-80s is due to the record high terms of trade. Had the terms of trade stayed at their 1990s average, the external deficit would now be 10 per cent, not 6.75 per cent, of GDP … These historic terms of trade cannot last and serve to conceal the true nature of Australia's external imbalance.[10]

3.20 Professor Garnaut made a similar point when he said that the recent high levels of CAD would have been even higher except for a fortuitous combination of events - Australia's very high terms of trade and very low international interest rates. He said:

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9 The OECD countries which appear to have CADs of roughly this magnitude are Iceland, Hungary, Greece, the Czech Republic and New Zealand, with the USA not far behind. OECD *Economic Outlook*, No. 77 June 2005, Annex Table 51.

10 *Official Committee Hansard*, 16 May 2005, p. E13. Mr Conroy's comments on the impact of the terms of trade are based on an article in the Australian Financial Review on 6 December 2004, *Beware the terms-of-trade elephant* by Mr Barry Hughes, who is described as an economic consultant to Credit Suisse and other groups.

> There are a couple of features of that big number [CAD of 7.2%] … it has occurred at a time of historically extremely high terms of trade … a time of unusually low global interest rates so that the financing demands of the large external liabilities are less severe than they would be in normal times for international interest rates. If international interest rates were near the average of the last 20 years, rather than historically extremely low, then that would add possibly a couple of per cent to the current account deficit.[11]

3.21 Dr Gruen disagreed as to the level of risk posed by future increases in international interest rates:

> In terms of servicing the foreign debt, I do not think that global interest rates are all that relevant. The ABS did a survey in 2001 of the hedging practices of Australian companies. They have just redone this survey and the results will be published later in the year. When the first survey was done, the ABS was given the answer that 77 per cent of the value of foreign currency denominated debt was hedged back to Australian dollars. That is more than three-quarters. If you hedge foreign currency debt back to Australian dollars, you effectively pay Australian interest rates. I do not know the results of the more recent survey, but, if that is a reasonable reflection of the situation as it is now, the servicing of Australia's foreign debt is largely in Australian interest rates, and a change in global interest rates has a relatively small effect on that.[12]

3.22 Mr Hawkins supported that assessment by Dr Gruen:

> … while we have large net external liabilities to GDP, as had some of the East Asian countries, we are much less vulnerable to a large movement in the exchange rate, because, as David [Gruen] commented earlier, we are not in a position where all our debt is in foreign currency and unhedged. A significant amount of our debt is in Australian dollars and a significant amount of the debt that is not is either hedged in financial markets or naturally hedged through the export flows that companies which have borrowed have.[13]

3.23 But Professor Garnaut cautioned that currency hedging is not risk-free:

> … I think we should not become too complacent about a high proportion of our foreign debt being hedged against currency risk, because there are specific terms to those hedging contracts and when they come to an end they have to be recontracted. And if there is any deterioration in our circumstances—in interest rates, perceptions of capacity to repay the debt of Australian entities or currency risk—then that will affect the terms on which the hedges are rolled over. So that can mean that a problem is phased

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11 *Proof Committee Hansard*, 15 August 2005, p. E3.

12 *Proof Committee Hansard*, 15 August 2005, p. E8. The ABS report referred to is expected to be published during October 2005.

13 *Proof Committee Hansard*, 15 August 2005, p. E14.

> in, if things turn against us, but it does not mean to say that you avoid the problem altogether.[14]

### *Is there a link between offshore borrowing and the current account?*

3.24 Offshore borrowing by banks and other financial institutions has increased in recent years.[15] The RBA estimates that the major Australian banks now consistently source around 25 per cent of their liabilities offshore.[16] This suggests that approximately $50 billion per year of funding is sourced from overseas.[17]

3.25 Although offshore borrowing as a transaction is recorded on the capital account (the counterpoint to the current account), is there a link between offshore borrowing and the current account? For example, could a large inflow of funds exert upward pressure on the value of a currency?

3.26 The Committee did not receive any direct evidence of a possible relationship between large inflows of offshore funds and the current account, but it would like to see Treasury undertake further research in this area.

### *Committee views*

3.27 The Committee agrees that the driver of the CAD in recent years has been the household sector which has gone on a spending spree.

3.28 There is evidence that the household sector is now more cautious than a couple of years ago. Household consumption increased by 3 per cent in 2004-05, well below its long-term average. In contrast, business investment increased about 12 per cent and appears to be replacing households as the main driver of economic growth.[18]

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14 *Proof Committee Hansard*, 15 August 2005, p. E34.

15 Between the September 2000 quarter and the March 2005 quarter gross foreign liabilities (other than direct investment liabilities) of financial corporations increased 60%, from $303 billion to $487 billion. As at the March 2005 quarter depository corporations represented 72% of the total. ABS *Balance of Payments and International Investment Position*, cat. 5302.0.

16 RBA, *Financial System Stability: some current observations*, address by John F Laker, Assistant Governor (Financial System), 16 May 2003, p. 4.

17 Table B03 *Banks – liabilities* in the RBA Bulletin indicates that as at 30 June 2005, the banks had overseas liabilities of $275 billion, an increase of $29 billion over the previous financial year.

18 The 2004-05 figures on household consumption and business investment are from the July 2005 publication of ABS *National Income, Expenditure and Product*, Cat. 5206.0.

3.29 The Committee does not agree with Treasury's view that there has been no obvious trend in the balance on current account. The evidence clearly suggests a long-term trend towards larger deficits.

3.30 Could we be in the beginning of a new and higher 'step' level for a CAD averaging around 6 per cent of GDP, as implied in Figure 3.2?

3.31 The long-term trend in the CAD warrants close monitoring by the Government. What would it mean for Australia if the CAD averages around 6% of GDP over an extended period? At what level does the CAD become unsustainable? The Committee believes that such questions need to be asked, researched and debated so that appropriate policy responses can be identified and adopted as required.

3.32 An intriguing issue is that of a possible relationship between the inflow of offshore borrowing and the current account. Can capital inflow of such dimensions exert upward pressure on a currency, with all the consequences of a higher-than-normal currency? Does it matter that much of the overseas borrowings by the financial sector have been for unproductive purposes, unlike corporate borrowings that would increase productivity and exports? Are these borrowings keeping the currency at levels that make it difficult for the export sector to compete in overseas markets? The Committee would like to see more research to clarify whether such linkages exist and their significance.

**Recommendation 1**

**The Committee recommends that Treasury undertakes more analysis related to the longer-term outlook for the current account, and publishes its findings to enhance public understanding and discussion.**

## Is the present level of Australia's net foreign liabilities a problem?

3.33 Australia's foreign liabilities have been increasing for many years, both in value and as a proportion of GDP, but do they pose a major risk to the economy at this stage? Table 3.2 shows details of Australia's net foreign debt and net foreign equity positions since 1980.

**Table 3.2: Australia's net foreign liabilities[19]**

| | **Net foreign debt** | | | **Net foreign equity** | | | **Total net foreign liabilities** |
|---|---|---|---|---|---|---|---|
| **As at 30 June** | **Net foreign debt $b** | **% of total net foreign investment %** | **% of GDP %** | **Net foreign equity $b** | **% of total net foreign investment %** | **% of GDP %** | **$billion** |
| 1980 | -7.9 | 29.0 | 6.1 | -19.4 | 71.0 | 15.1 | -27.4 |
| 1985 | -53.1 | 67.2 | 23.5 | -25.9 | 32.8 | 11.5 | -78.9 |
| 1990 | -130.8 | 75.7 | 34.0 | -42.0 | 24.3 | 10.9 | -172.8 |
| 1995 | -190.8 | 74.7 | 40.6 | -64.7 | 25.3 | 13.8 | -255.5 |
| 2000 | -272.6 | 82.9 | 43.7 | -56.1 | 17.1 | 9.0 | -328.8 |
| 2005 | -430.0 | 83.2 | 49.8 | -86.9 | 16.8 | 10.1 | -516.8 |

Sources: ABS, *Balance of Payments and International Investment Position* (Cat. No. 5302.0); ABS, *National Income, Expenditure and Product* (Cat. No. 5206.0)

3.34 Most of the foreign investment coming into Australia now is in the form of debt (borrowings) rather than equity investment, as shown in Table 3.2 and graphically in Figure 3.3. As at June 1980, 29.0 per cent of foreign investment came into Australia in the form of borrowings and 71.0 per cent was in the form of equity investment in Australian companies. By June 2005 the proportions had reversed with 83.2 per cent coming in as borrowings and 16.8 per cent coming in as equity investment.

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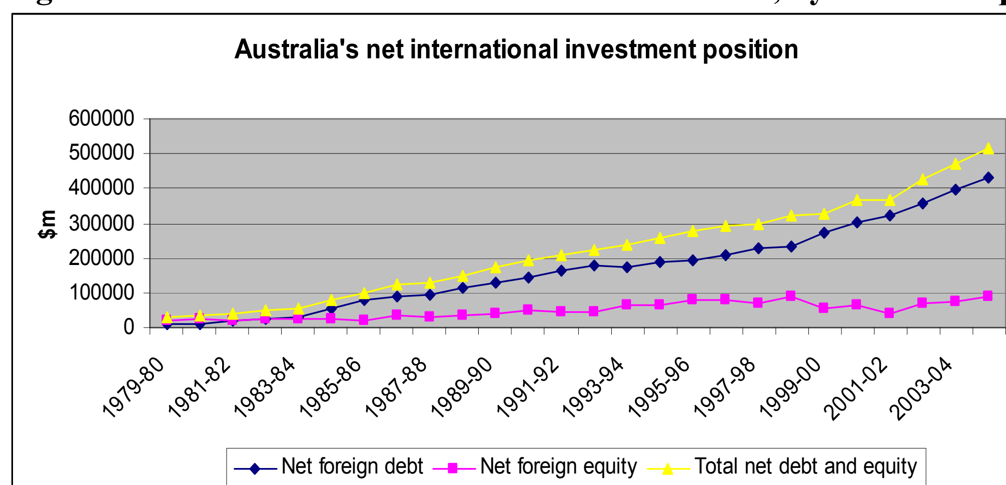
[19] Also referred to in ABS publications as the 'net international investment position'. The term 'net foreign investment' is also sometimes used. This report generally uses the term 'net foreign liabilities'.

**Figure 3.3: Australia's net international investment, by debt and equity.**




Source: ABS, *Balance of Payments and International Investment Position* (Cat. No. 5302.0).

3.35 Table 3.3 shows the major sources of foreign debt (borrowings) in the last four calendar years. Note that this is total or gross foreign debt, whereas the amounts in Table 3.2 are for net foreign debt.

**Table 3.3: Major sources of foreign debt (borrowing) in Australia, calendar years**

| Country | 2001 | 2002 | 2003 | 2004 | 2001 | 2002 | 2003 | 2004 |
|---|---|---|---|---|---|---|---|---|
| | As at 30 December, $ billion | | | | % of total | | | |
| UK | 123.8 | 150.8 | 155.3 | 179.1 | 24.3 | 26.2 | 25.4 | 25.6 |
| USA | 114.4 | 136.7 | 159.0 | 165.1 | 22.5 | 23.7 | 26.0 | 23.6 |
| International Capital Markets | 90.0 | 94.7 | 98.4 | 137.9 | 17.7 | 16.5 | 16.1 | 19.7 |
| Unallocated | 25.6 | 26.9 | 33.1 | 50.3 | 5.0 | 4.7 | 5.4 | 7.2 |
| Japan | 33.6 | 32.3 | 27.2 | 25.7 | 6.6 | 5.6 | 4.5 | 3.7 |
| Belgium / Luxembourg | 9.0 | 7.3 | 10.9 | 17.7 | 1.8 | 1.3 | 1.8 | 2.5 |
| Hong Kong | 26.1 | 29.6 | 21.0 | 16.8 | 5.1 | 5.1 | 3.4 | 2.4 |
| Singapore | 22.8 | 20.8 | 17.6 | 15.0 | 4.5 | 3.6 | 2.9 | 2.1 |
| Total all countries | 508.6 | 575.5 | 611.4 | 699.2 | 100 | 100 | 100 | 100 |

Source: ABS, *International Investment Position, Australia: Supplementary Country Statistics 2004* (Cat No. 5352.0)

3.36 These figures raise the question whether lenders in Japan, Hong Kong and Singapore could be losing confidence in Australia (perhaps because of the consistently high current account deficits we have recorded in recent years?). Fortunately the biggest lenders to Australia, the UK and USA, do not appear to share these concerns.

3.37 As at 30 June 2005, official (i.e. government) gross foreign debt liabilities (borrowings) totalled $32.4 billion while official foreign debt assets and reserve assets totalled $64.1 billion. So the government sector is in surplus.[20]

3.38 As at 30 June 2005, of Australia's total gross foreign liabilities $275.8 billion was repayable in Australian dollars (38.9%) and $433.4 billion was repayable in foreign currencies (60.1%).[21] Borrowings in US dollars represented 56 per cent of total foreign currency borrowings as at 30 June 2005.[22]

3.39 The Round Table considered various aspects of Australia's foreign liabilities. Mr Hawkins pointed out that on several counts Australia's foreign debt did not pose major problems:

> There are three aspects that people consider in looking at whether or not a debt is a problem. One aspect is the public-private ratio, and the fact that ours is predominantly private is better than it being predominantly public. The second aspect is the currency in which the debt is denominated. In the classic cases of countries having debt crises, all of the debts have been in foreign currencies. In Australia's case, quite a lot of our debt is in Australian dollars or is hedged one way or another. The third aspect is the maturity structure of the debt. Ours is around the OECD average. It is certainly not all short-term debt, as has been the case in some countries that have had a crisis.[23]

3.40 However, Professor Garnaut pointed out that having predominantly private sector debt is not risk-free:

> I am not seeking to draw a parallel between Australia and any of the East Asian countries that went into crisis, but until right on the point of the crisis, in the main, those economies had consenting-adult deficits, mainly driven by debt-funded assets booms in the private sector. We are taking comfort from the consenting-adults view of debt and the fact that it is in the private sector. There have been lots of circumstances in other countries where that has looked like a comfort for a while and then quite quickly has

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[20] RBA Bulletin, Table H6. On 24 September 2005 the Australian Financial Review reported that the Commonwealth Government recorded an underlying cash surplus of $13.6 billion in 2004-05. *Budget surplus swells by $4.4 bn,* AFR, 24 September 2005, p. 5.

[21] RBA Bulletin, Table H4. The proportion of gross borrowings in Australian dollars fluctuates but has always been below half of the total. The highest proportion - 45.3% - was recorded at 30 June 1997.

[22] US dollar loans usually represent between half and two-thirds of total foreign currency loans.

[23] *Proof Committee Hansard*, 15 August 2005, p. E33.

> ceased to be a comfort. Even in our own history, the most severe depression we ever had, in the 1890s, followed the deflation of a private sector asset boom: the great housing boom of the late eighties, which extended into 1890 and then collapsed, which was greatest in Melbourne but had Australia-wide ramifications in the early 1890s. It was not principally a problem of government debt, and yet the consequences were severe.[24]

3.41 On the question whether equity is better than borrowings Mr Pearson commented:

> There is no 'right' form of foreign capital inflow. Debt is not 'bad' and equity is not 'good'. Remember, if you go back in the political debate in Australia there was a time when people did not want to have equity, because they thought that was 'selling off the farm', and the alternative was to have debt. Neither is better or worse. They have different servicing obligation characteristics and different ownership characteristics, which are neither good nor bad. They are just different.[25]

3.42 Professor Garnaut observed:

> On the question of debt versus equity, if the concern that we have about an unusually large current account deficit is that, in certain circumstances, it would make us vulnerable to the need for painful adjustment, selling off a lot of equity leaves us less vulnerable than selling off a lot of debt, because if our economy comes upon harder times then the equity that foreigners hold loses value; foreigners share in that adjustment.[26]

3.43 Mr Hawkins indicated that the maturity structure of the debt is about average for the OECD economies,[27] and Mr Pearson provided the following detail:

> On the question of foreign debt, the latest figures up to the March [2005] quarter were that there is about $370 billion of gross foreign debt in risk liabilities of more than one year's maturity. The total outstanding is about $690 billion. That is, more than half have more than one year's maturity.[28]

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24 *Proof Committee Hansard*, 15 August 2005, p. E4. The term 'consenting-adults deficit' describes a deficit which is made up of largely private sector debt and the foreign lenders who are providing the money seem to be quite willing to lend as much as is required.

25 *Proof Committee Hansard*, 15 August 2005, p. E34.

26 *Proof Committee Hansard*, 15 August 2005, p. E35.

27 *Proof Committee Hansard*, 15 August 2005, p. E34.

28 *Proof Committee Hansard*, 15 August 2005, p. E35.

### *Servicing Australia's foreign liabilities*

3.44 The financing of a deficit on the current account produces an increase in foreign liabilities.[29] Dr Gruen commented that, while net foreign liabilities as a proportion of GDP cannot increase indefinitely, he did not see the present circumstances as posing a particular threat to Australia. He said:

> As a consequence of that [current account deficits], net external liabilities as a proportion of the size of the economy have been gradually rising. But, again, that has been true for 20 years, and I do not think there are any magic numbers here. At some point, net external liabilities to GDP have to stop rising. They cannot go on going up forever, but it is far from obvious how much further net external liabilities to GDP could rise. I do not think it indicates emerging structural problems in the economy. In the broad, I think it is a continuation of something that we have seen for an extended period.[30]

3.45 Debt service ratios provide an indication of the ability of a country to service its foreign liabilities. Table 3.4 shows how Australia's debt service ratios have changed since 1990.

**Table 3.4: Debt service ratios, 1990 - 2005**

| June quarter | Net interest payments to exports, % | Net income[31] payments to exports, % | Net interest payments to GDP, % | Net income payments to GDP, % |
|---|---|---|---|---|
| 1990 | 19.6 | 25.0 | 3.1 | 4.0 |
| 1993 | 12.2 | 16.5 | 2.2 | 3.0 |
| 1996 | 11.5 | 19.7 | 2.3 | 3.9 |
| 1999 | 9.4 | 16.5 | 1.8 | 3.1 |
| 2002 | 8.9 | 12.8 | 1.9 | 2.8 |
| 2005 | 9.5 | 19.2 | 1.8 | 3.6 |

Source: RBA Bulletin, *Australia's service payments on net foreign liabilities*, Table H7.

3.46 The figures in Table 3.4 show that net interest payments as a percentage of export earnings almost halved between 1990 and 2002, but that ratio is now edging up. The early 1990s was a period of very high interest rates, and Australia obviously benefited from the significant fall in interest rates in subsequent years (see Figure 3.4 below).

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29 Appendix 3 has an explanation of the relationship between the CAD and net foreign liabilities.

30 *Proof Committee Hansard*, 15 August 2005, p. E2.

31 Net income payments comprise net interest payments plus net payments of dividends and reinvested earnings.

3.47 However, the ratio of net income payments as a percentage of exports is again getting uncomfortably close to 20%. This ratio reflects both interest payments and dividend payments and reinvested earnings. Foreign shareholders appear to be reaping the benefits of their equity investments in Australian companies.

3.48 The high ratings given to Australia by the international rating agencies suggest that they continue to regard Australia's debt service ratios as manageable, despite the sharp increase in the net income payments ratio in the last 3 years. On this point Professor Garnaut commented:

> We have been able to finance the large current account deficit because the international financial markets, the various sources of capital - equity and debt—and other instruments of capital transfer have not formed a view that the Australian deficit is unsustainable.[32]

3.49 Later in the discussion Dr Gruen made a similar point:

> The reason we were re-rated back up to AAA by the rating agencies, even though the current account deficit remained large, was precisely because their view about the rest of the economy was that it was more resilient and that it was performing well based on a wide range of other factors.[33]

3.50 Mr Potter made the observation that the international rating agencies are experienced judges of risk:

> What else, other than the international ratings agencies, can we use to indicate independently that it [a high CAD] is a problem? Saying it is at historical highs does not really indicate anything much.[34]

3.51 Mr Conroy commented:

> The AMWU believe that foreign debt is not a problem as long as foreigners are happy to hold Australian debt - which they have been in recent years because of Australia's AAA credit rating and high interest rates relative to the rest of the world[35].

3.52 But Mr Conroy went on to caution that the differential between Australian and US interest rates would decrease as US rates go up. That will put pressure on the Reserve Bank to lift Australian interest rates with potentially dire results for the local economy.

3.53 As we have seen with movement of the net income payments ratio, debt service ratios can change quickly if economic circumstances change. Figure 3.4 shows that international interest rates have been at historical lows, but some rates are

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32 *Proof Committee Hansard*, 15 August 2005, p. E4.

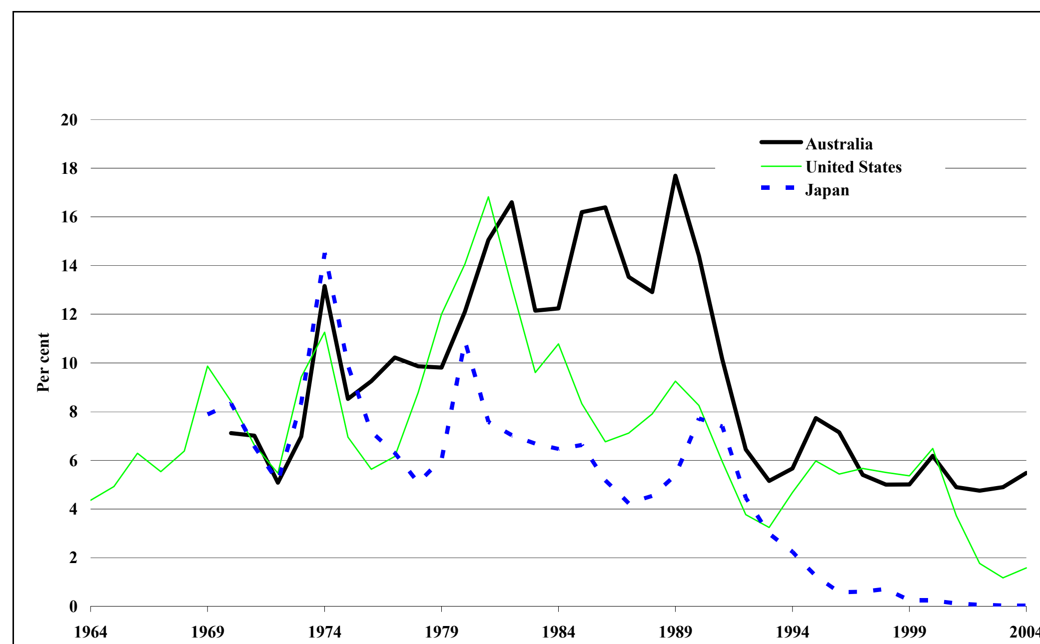
33 *Proof Committee Hansard*, 15 August 2005, p. E31.

34 *Proof Committee Hansard*, 15 August 2005, p. E32.

35 *Official Committee Hansard*, 16 May 2005, p. E13.

now showing signs of moving up. That trend is already starting to be reflected in the higher interest payments ratios shown in Table 3.4. There is little to suggest the net interest payments ratio will not worsen in the foreseeable future.

**Figure 3.4: Short term interest rates, Australia, USA and Japan, 1964 – 2004**




Source: RBA Bulletin datastream

3.54 The recent upturn in US and UK interest rates is evident in Table 3.5, which shows the movement in interest rates in seven countries since 2000.

**Table 3.5: Short term interest rates, selected countries, 2000 - 2005**

| Country | Calendar year annual average % | | | | | Month of June 2005, % |
|---|---|---|---|---|---|---|
| | 2000 | 2001 | 2002 | 2003 | 2004 | |
| USA | 6.5 | 3.7 | 1.8 | 1.2 | 1.6 | 3.2 |
| UK | 6.1 | 5.0 | 4.0 | 3.7 | 4.6 | 4.8 |
| Japan | 0.2 | 0.1 | 0.1 | 0.0 | 0.0 | 0.0 |
| Germany | 4.4 | 4.3 | 3.3 | 2.3 | 2.1 | 2.0 |
| EU av. | 4.8 | 4.4 | 3.5 | 2.6 | 2.6 | 2.6 |
| Canada | 5.7 | 4.0 | 2.6 | 3.0 | 2.3 | 2.6 |
| Australia | 6.2 | 4.9 | 4.8 | 4.9 | 5.5 | 5.7 |

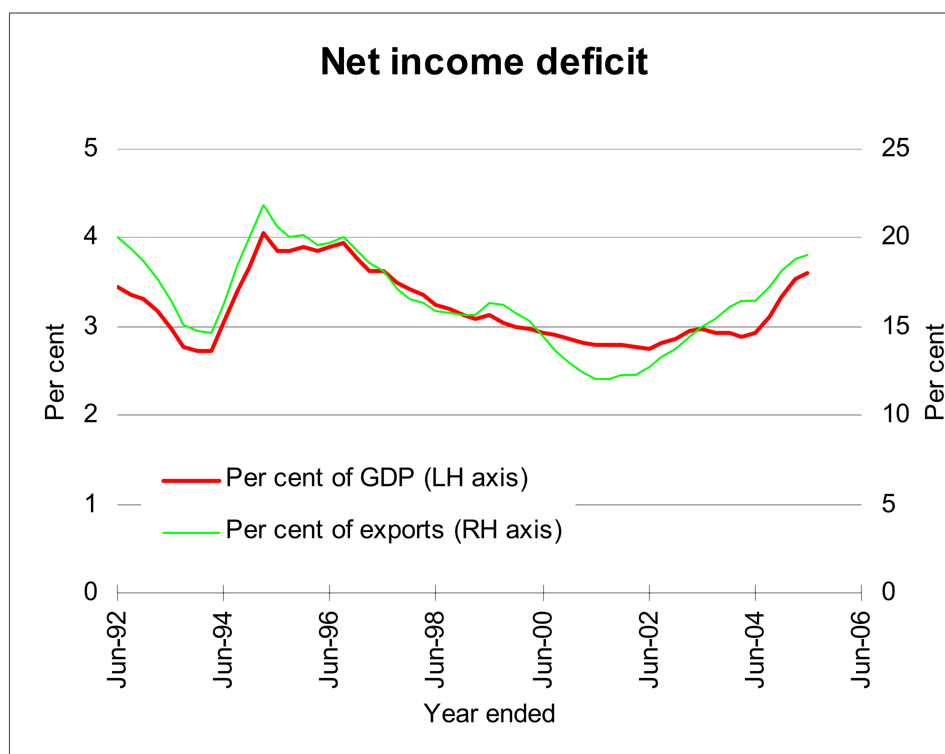
Source: RBA Bulletin datastream

3.55 Low international interest rates have benefited Australia. For example, while Australia's net foreign debt increased by $257 billion between June 2000 and June 2005, net interest payments to service the debt only went from $14.6 billion in 2000-01 to $15.4 billion in 2000-05, as shown in Table 3.6 below.

### *Committee views*

3.56 The May 2001 edition of Treasury's Economic Roundup bulletin contained an article titled *'The net income deficit over the past two decades*'. The article found that the net income deficit had shown steady improvement (i.e. decrease) since the mid-1990s, which augured well for Australia's future ability to finance its foreign liabilities. However, that trend of steady improvement in the net income deficit between 1996 and 2002 has not continued, with the trend reversing and the net income deficit sharply worsening in the last year as shown in Figure 3.5.

**Figure 3.5: Net income deficit as a percentage of exports and of GDP**




Sources: ABS, *International Trade in Goods and Services* (Cat. No. 5368.0) - for export data; ABS, *National Income, Expenditure and Product* (Cat. No. 5206.0) - for GDP data; *Reserve Bank of Australia Bulletin*, Table H7 - for net income payments

3.57 Table 3.6 shows Australia's net foreign liabilities (debt and equity) and the amounts used to service those liabilities over the last six years. The Committee notes with concern that the net income balance has deteriorated sharply, from -$18.2 billion in 2000-01 to -$31.2 billion in 2004-05.

**Table 3.6: Net foreign liabilities and their annual servicing amounts, $billion**

| | Net foreign debt, as at 30 June | Net interest payments over 12 months | Net foreign equity, as at 30 June | Other net income payments over 12 months | Total net income balance over 12 months |
|---|---|---|---|---|---|
| 1999-2000 | -272.6 | -13.4 | -56.1 | -4.8 | -18.2 |
| 2000-01 | -302.5 | -14.6 | -63.1 | -4.1 | -18.7 |
| 2001-02 | -324.2 | -13.6 | -41.0 | -5.7 | -19.3 |
| 2002-03 | -357.9 | -11.6 | -70.3 | -9.9 | -21.5 |
| 2003-04 | -394.7 | -12.5 | -75.8 | -11.2 | -23.7 |
| 2004-05 | -430.0 | -15.4 | -86.9 | -15.8 | -31.2 |

Source: Derived from RBA monthly bulletin, Tables H5 and H7.

3.58 This deterioration is also reflected in the debt service ratios shown in Table 3.4 and shown graphically in Figure 3.5, above. After several years of improving ratios, net income payments as a percentage of exports jumped from 12.8 per cent to 19.2 per cent in three years. Over the same period net income payments as a percentage of GDP rose from 2.8 per cent to 3.6 per cent

3.59 While these figures are still below the highs reached in the December 1990 quarter (26.5 per cent and 4.3 per cent respectively), the Committee considers that recent trends are worrisome.

3.60 The Committee is puzzled by the sharp increase in the category 'other net income payments' (basically, dividends and reinvested earnings paid to foreign equity holders). Most commentators suggest that this is a result of the very high corporate profits earned in Australia in the last couple of years, but can that be the whole story behind a four-fold increase in just five years (from $4.1 b in 2000-01 to $15.8 b in 2004-05)? Such a dramatic change begs for a clearer explanation by Treasury.

3.61 The Committee received conflicting evidence in relation to the likely impact of movements in international interest rates on the income balance. Professor Garnaut believes that if international interest rates go back to historical average levels, that would have a significant impact on Australia's income balance and possibly add a

couple of points to the CAD. However, the Treasury representatives (Dr Gruen and Mr Hawkins) argue that hedging of foreign borrowings by Australian banks has greatly reduced the risks posed by higher international interest rates.[36]

3.62 The Committee considers that it would be useful for Treasury to undertake some modelling of various scenarios (such as a rise in international interest rates, and a fall in the terms of trade), to ascertain what impact such changes would have on the current account. The results of that research should be published to facilitate understanding and debate on this important issue. The Committee is concerned at recent trends, and believes that it would be useful for Treasury to regularly publish detailed analyses of developments in the trade balance and income balance.

## Why are exports important?

3.63 Exports are important because, together with imports, they make up the trade balance. If exports grow faster than imports, the trade balance improves and there is a likelihood that the current account deficit may decrease. However, if export growth is slower than import growth, then the deficit in the trade balance widens which puts pressure on the current account.

3.64 So, two key issues to consider are the prospects for a better performance by exports in the future, and whether it is realistic to hope for regular trade surpluses.

3.65 After matching import growth for most of the 1990s, export growth slowed in 1997. It then grew rapidly, to such an extent that in 2000-01 exports actually exceeded imports. But since that time export growth has again fallen behind import growth.[37]

3.66 Figure 3.6 shows how exports have performed. After solid growth through the 1990s they grew very quickly during 1999-2001. However, they declined in 2002 and 2003 and are only now picking up again due to higher prices of mineral and energy exports.

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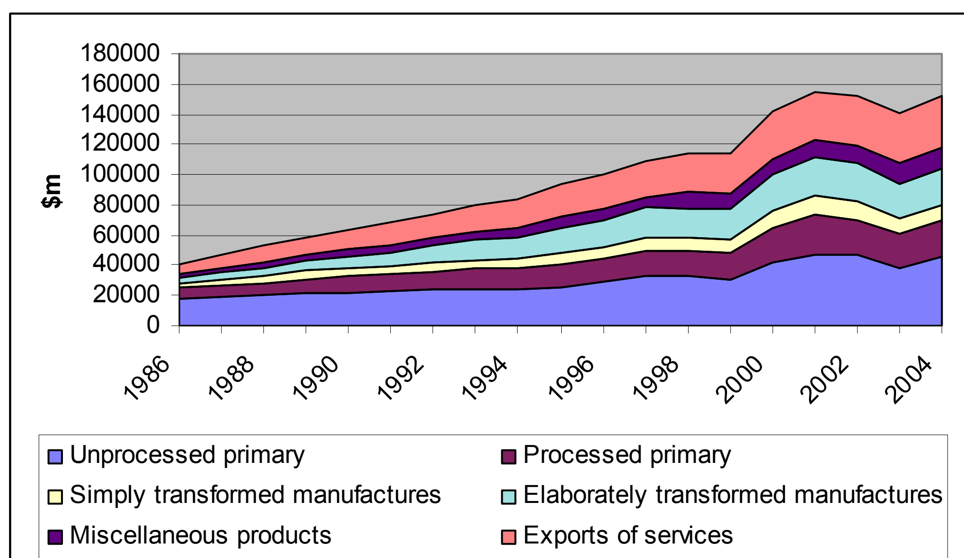
36 See discussion in paras 3.21 to 3.23.

37 See Figures 4 and 5 in Chapter 2 for details of Australia's imports and exports of goods and services 1971 – 2005.

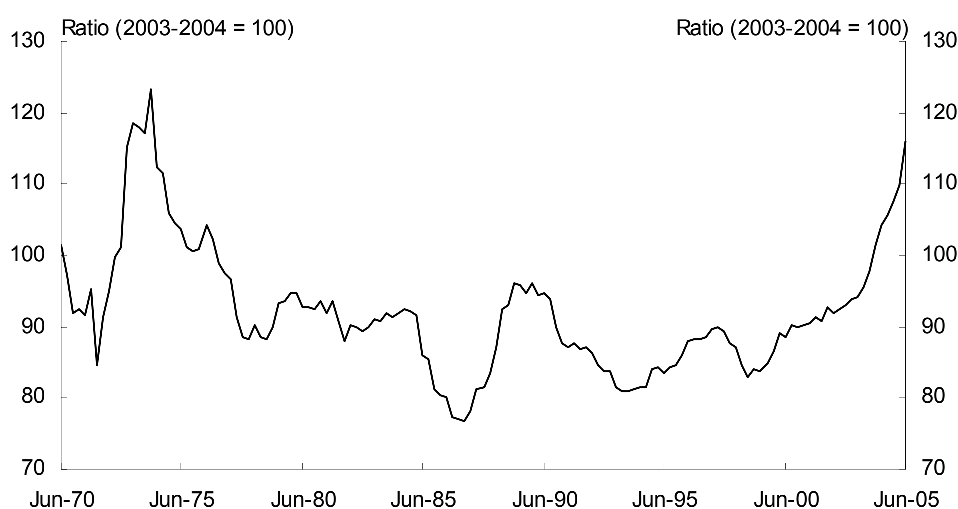
**Figure 3.6: Exports of Goods and Services**




Sources: Department of Foreign Affairs and Trade (DFAT), *Exports of Major Commodities Time Series*; DFAT, *Exports of Primary and Manufactured Products Australia*; ABS, *Balance of Payments and International Investment Position* (Cat. No. 5302.0)

3.67 The commodity boom has pushed up the price of exports relative to imports with the result that Australia's terms of trade are at 30 year highs as shown in Figure 3.7. The terms of trade are expected to settle back to more normal levels in the next few years.

**Figure 3.7: Terms of trade, quarterly**




Source: Australian Bureau of Statistics cat. no. 5206.0.

3.68 A rise in the terms of trade adds to real national income. According to Treasury's submission: 'While real GDP expanded by 1½ per cent through 2004, the rise in the terms of trade meant that real national income grew by almost 3 per cent'.[38]

3.69 If export prices are so high, why have export revenues not accelerated? The Treasury submission provides one explanation:

> There is currently very strong demand for our resource exports. This is reflected in high prices for these exports, but so far there has been little rise in export volumes. This is partly due to firms underestimating the strength of global demand and the lags associated with expanding capacity. Furthermore, the diversity of ownership of the various linkages between mines and ships has made coordination of improvements to transport and port facilities difficult. Nevertheless, there is a substantial amount of investment currently under way, which should allow significant expansion in these exports in coming years.[39]

3.70 While Treasury is confident that export volumes for resource exports will pick up shortly, it is less sanguine in relation to exports of manufactures for the following reasons:

> The volume of manufactures exports has been weak for some time. This reflects maturing of the sector, the appreciation of the Australian dollar, growing sophistication of Asian competitors and perhaps some diversion of production as a result of high domestic demand.[40]

3.71 The export of Elaborately Transformed Manufactures (ETMs) and Services both grew strongly from the mid-1980s to late 1990s, increasing their share of total exports and increasing their contribution to GDP. However, both have slowed significantly in recent years, as shown in Figures 3.8 and 3.9.

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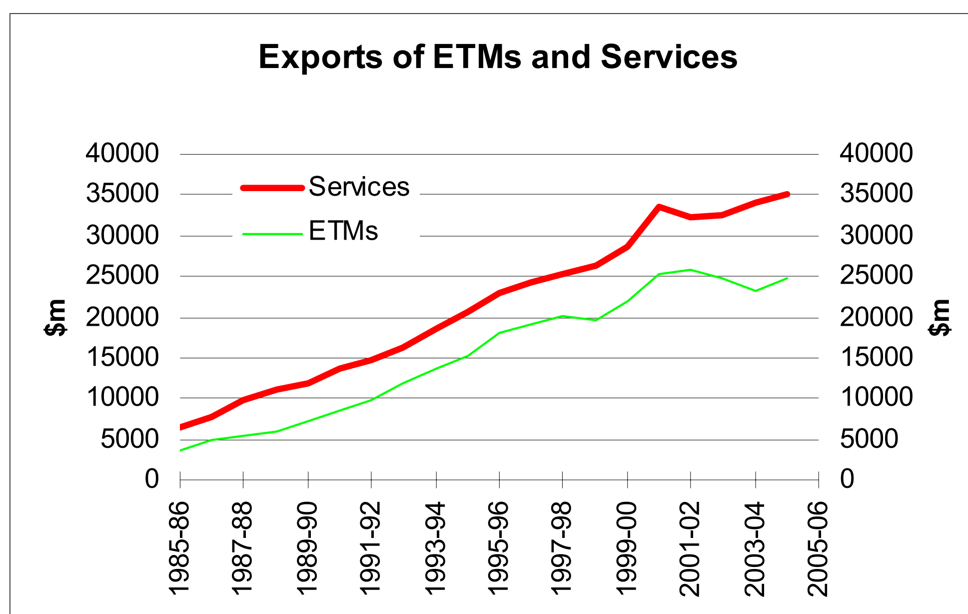
[38] The Treasury, *Submission 13*, p. 4. The ABS announced the national accounts figures on 7 September 2005. In seasonally adjusted terms, GDP increased by 1.3% in the June quarter. Very strong growth in the terms of trade (up 5.8%for the June quarter and 11.5% for 2004-05) is reflected in strong growth in real net national disposable income of 3.1% in the June quarter with a total of 4.3% for 2004-05. ABS Cat. 5206.0

[39] *Submission 13*, p. 3.

[40] *Submission 13*, p. 3.

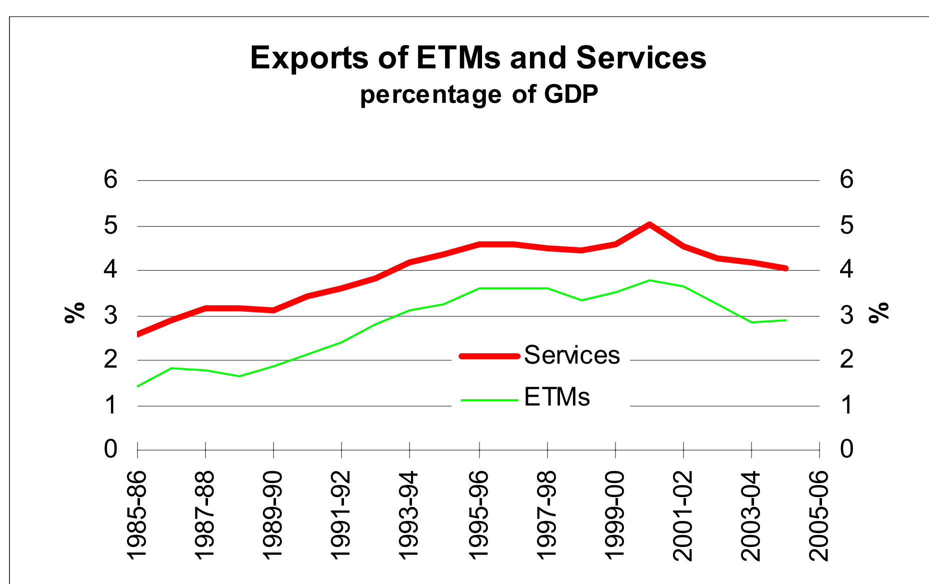
**Figure 3.8: Exports of Elaborately Transformed Manufactures and Services**




Sources: Department of Foreign Affairs and Trade (DFAT), *Exports of Major Commodities Time Series*; DFAT, *Exports of Primary and Manufactured Products Australia*; ABS, *Balance of Payments and International Investment Position* (Cat. No. 5302.0)

3.72 The declining contribution to the economy made by exports of ETMs and services since about 1997 is apparent when they are shown as a percentage of GDP, as in Figure 3.9.

**Figure 3.9: Exports of ETMs and Services as a percentage of GDP**




Sources: Department of Foreign Affairs and Trade (DFAT), *Exports of Major Commodities Time Series*; DFAT, *Exports of Primary and Manufactured Products Australia*; ABS, *Balance of Payments and International Investment Position* (Cat. No. 5302.0)

3.73 In Australia high terms of trade normally reflect high commodity prices, and the exchange rate usually moves in sympathy with the terms of trade. That means exports become relatively more expensive and over time tend to fall, while imports become relatively cheaper and tend to rise. Receipts for exports of commodities reflect the higher export prices, but manufactured products and services feel the impact of the higher exchange rate and tend to fall.

3.74 Professor Garnaut pointed out that a number of periods of economic prosperity ended when there was a sharp fall in the terms of trade - as a result of which the exchange rate falls, inflationary pressures increase, interest rates rise, investment falls, and government revenue (and expenditure) falls. He said:

> I am not predicting a large and sudden retreat of the terms of trade, but one has to recognise that it is historically normal to get these corrections, so it is one of things that we should turn our minds to. If that were accompanied by a lift in global interest rates, increasing the cost of servicing our external debt, it would put an additional burden on our external accounts.[41]

3.75 Dr Simes noted that exports of ETMs and services grew quickly from the mid 1980s to the late 1990s, due to a combination of factors such as the low exchange rate; the removal of tariffs which made local firms more internationally competitive; and the intensified engagement with Asia. But the situation has changed:

> If you look at the situation today, we have got a much more open economy - that is, the imports to GDP is much higher than it was then [in the 1980s] … it is hard to conceive of a scenario where we are going to get a lot of mileage from the rural sector … it is hard to see a situation where we get a long-term big boost from the mining sector also. A lot of the big boost we have at the moment is coming off the terms of trade … the focus needs to come back to … do something a bit more proactive on manufacturing and services.[42]

3.76 Mr Hawkins pointed out that the greater diversity of Australia's exports makes us less vulnerable. While Professor Garnaut agreed with that assessment, he called for a careful analysis of the reasons for the recent slowdown in exports of ETMs and services. He said:

> It is very important to the diminution of vulnerability in future that we understand that slowdown [in exports]. My thoughts would go not to new interventions by government to artificially increase incentives to those sectors but to understanding the barriers of various kinds that have emerged to continued rapid growth in services and manufacturing exports.[43]

3.77 Mr Potter agreed with Professor Garnaut – 'I understand what you are saying: we should not be looking at industry specific measures to artificially promote a sector,

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41 *Proof Committee Hansard*, 15 August 2005, p. E5.

42 *Proof Committee Hansard*, 15 August 2005, p. E16.

43 *Proof Committee Hansard*, 15 August 2005, p. E17.

but we might want to look at industry-specific barriers to those particular industries. I think that is absolutely correct.' [44]

3.78 Mr Conroy saw innovation as the key to increasing exports of ETMs:

> We believe that if we increase innovation in the industry, and in manufacturing in particular, it will increase our long-term competitiveness and our exports because we could then compete with Asian countries not on the price of labour - which we can never win - but on the price of our innovation and keeping ahead of the curve.[45]

### *Committee views*

3.79 It seems to the Committee that there is little prospect that Australia's net income balance will improve over the short-to-medium term. If anything, the deficit on the income balance is likely to worsen given the combination of rising net foreign liabilities and rising US and UK interest rates. So if there is to be a significant improvement in the CAD it will most likely have to come from the trade balance. But how realistic is such an expectation?

3.80 For the trade balance to have a significant impact on the CAD, exports must consistently grow faster than imports. The ideal situation would be for Australia to run a trade balance surplus on a regular basis.

3.81 The Round Table noted that the short term prospects are for strong growth exports, driven by high export prices for minerals and energy and increased export volumes as infrastructure capabilities are expanded. But if China's extraordinary growth falters, that scenario could quickly change.

3.82 Most of the discussion focused on the need to improve the export performance of ETMs and services, which had stalled in recent years.

3.83 The Committee agrees that exports of ETMs and services must perform well if there is to be a medium-to-long term improvement in the trade balance. Unfortunately the Round Table did not have sufficient time to consider possible strategies to achieve that goal but in any case that is the role of the Australian Trade Commission (Austrade).[46]

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44 *Proof Committee Hansard*, 15 August 2005, p. E17.

45 *Official Committee Hansard*, 16 May 2005, p. E17.

46 Austrade is part of the DFAT portfolio. It has a wide network of over 100 offices in 50 countries, which is a major commitment of resources by the Government. Other Government agencies involved include the Department of Foreign Affairs and Trade in relation to trade policy; and the Department of Industry, Tourism and Resources in relation to industry policy.

3.84 Austrade is the Government's export promotion agency. Its focus is on the export of ETMs and services, as commodities are internationally traded goods and exports of commodities basically look after themselves.

3.85 Austrade's priority for the last 5 years has been to double the number of exporters. To achieve that goal Austrade has concentrated its efforts on small-to-medium sized companies. Realistically, such companies will make very little difference to Australia's overall exports for many years to come. Large companies, with the necessary financial and management resources, are the only ones which can make a significant impact. Australia needs to nurture manufacturers and service companies which export $10 million per annum, not $10 000.

3.86 The recent falling off of export growth suggests that Austrade should urgently re-assess its priorities.

3.87 The Committee urges Austrade to develop strategies which will increase the export of ETMs and services on a sustainable basis. Exports as a whole, and in particular ETMs and services, need to grow at a faster rate than imports for the next few years if there is to be any chance for the CAD to achieve a significantly lower average level.

**Recommendation 2**

**The Committee recommends the Government develop new strategies to promote the export of Elaborately Transformed Manufactures and services to underpin a long term improvement in the balance of trade.**

## What are the links between household debt, imports and the CAD?

3.88 The overall aim of this Inquiry was to explore possible links between household debt, demand for imported goods and the current account deficit (CAD). One of the specific terms of reference was to look at 'the extent to which demand for imported goods by Australian households contributes to the current account deficit'.

3.89 Mr Conroy saw a direct link between household consumption and imports and the CAD. He said:

> The explosion in the current account deficit in the last five years has been driven by an increase in imports. It is not about borrowing more to fund capital expansion here; it is about borrowing more and buying more consumer goods. If you look at the growth rates in the last eight years, consumer goods have risen by about 140 per cent and capital good imports only by 70 per cent, so what is happening is that Australians are buying more and more consumer goods from overseas. This is part of an underlying structural problem here in that we are not funding productive

> investment; we are borrowing now to purchase goods and we will pay for it later …[47]

### Households and the CAD

3.90 There is a direct link between household debt and the current account deficit. As discussed in Chapter 2, from a savings/investment perspective, household debt has been the principal contributor to the CAD in recent years.[48]

3.91 The official or government sector is now a net lender (that is, the government sector is in overall budget surplus). The private sector is made up of corporations and households. Corporations have traditionally been heavy borrowers but in the last couple of years they have become net lenders as high profits have exceeded investment. In contrast, households have traditionally been net lenders but in recent years they have become net borrowers. Since about 2000-01 household spending/debt has been the main driver of the current account deficit.

### Imports and the CAD

3.92 There is also a direct link between imports and the CAD in the sense that imports are part of the trade balance which, in turn, is a major component of the current account - see discussion on the trade balance in paragraphs 2.10 to 2.20 in Chapter 2.

### Households and imports

3.93 One could reasonably expect a link between households and imports, particularly imports of consumption goods. Households consume both domestically produced goods and services, and imported goods and services. These might be direct purchases of imported televisions or cars or indirect purchases of, for example, kitchen appliances if a house they buy is fitted with imported kitchen appliances.

3.94 Figure 3.10 shows the result of plotting the movement of household liabilities against imports of consumption goods in the period 1987-88 to 2003-04, both measured at constant prices. Superficially, the graph suggests a strong linear relationship between these two variables (reflected in the high regression coefficient of 0.9711). However, it would be premature to read too much into this graph without further research to more definitely establish the causal links.

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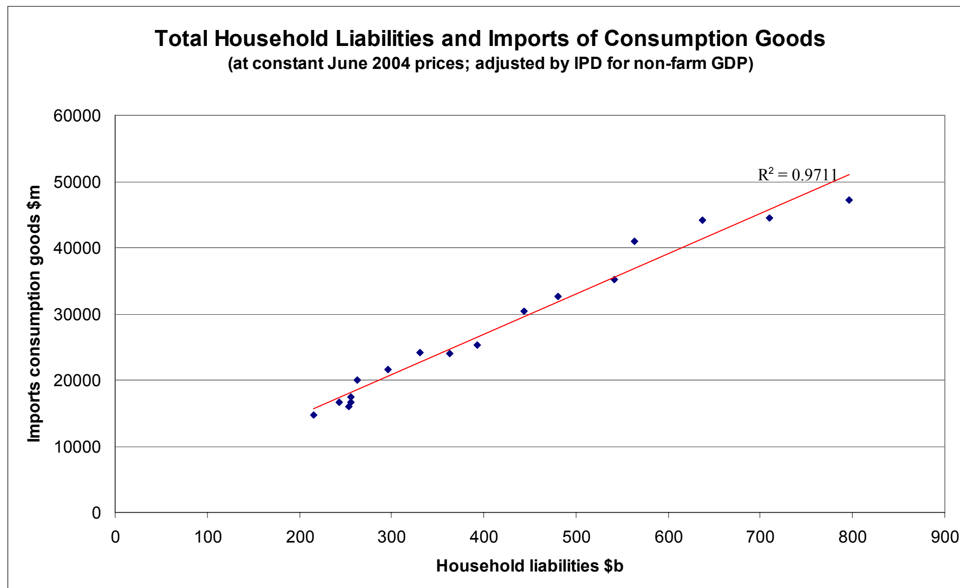
47 *Official Committee Hansard*, 16 May 2005, p. E15.

48 See discussion in paras 2.21 to 2.26 in Chapter 2.

**Figure 3.10: Statistical correlation between household liabilities and imports of consumption goods**

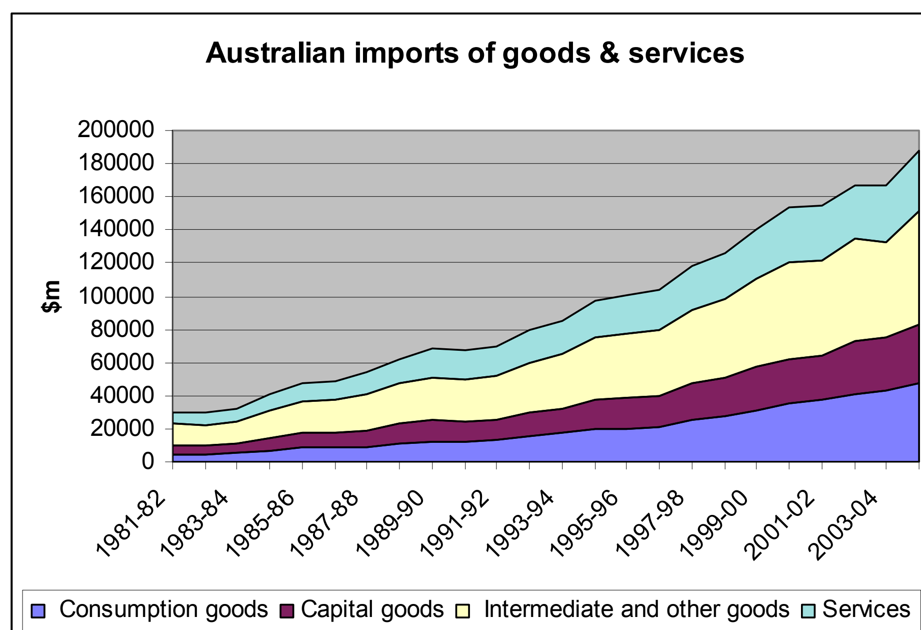



Sources: ABS, *Financial Accounts* (Cat. No. 5232.0) - for total household liabilities; ABS, *National Income Expenditure and Product* (Cat No. 5206.0) - for the implicit price deflator for non-farm GDP; ABS, *International Trade in Goods and Services* (Cat. No. 5368.0) - for imports of consumption goods.

3.95 Imports of consumption goods have grown strongly in recent years, driven by strong consumer demand. Strong Asian competition and an appreciating Australian dollar have helped to keep prices of imported manufactured goods relatively low.

3.96 Figure 3.11 shows how imports of goods and services have increased since 1981-82, and Figure 3.12 is a representation of how the major components of total imports have changed. This shows that imports of consumption goods have increased at a faster rate than the other components, thus increasing their share of total imports of goods and services.

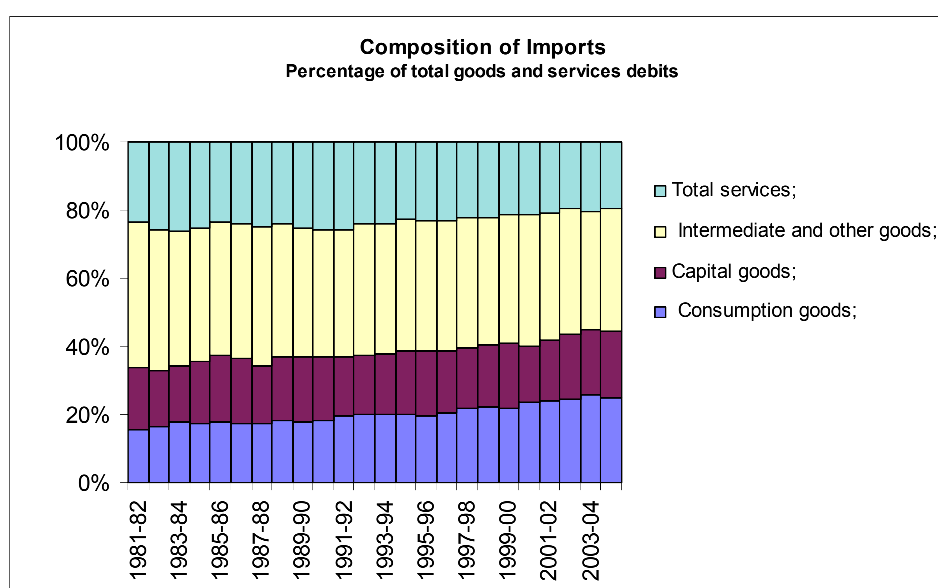
**Figure 3.11: Imports of goods and services, by major components**




Source: ABS, *International Trade in Goods and Services* (Cat. No. 5368.0)

3.97 Figure 3.12 shows the percentage of total imports represented by its four components: consumption goods; capital goods; intermediate goods; and services. Consumption goods have increased their share of the value of total imports of goods and services from 16 per cent in 1981-82 to 25 per cent in 2004-05, largely at the expense of intermediate goods and services.

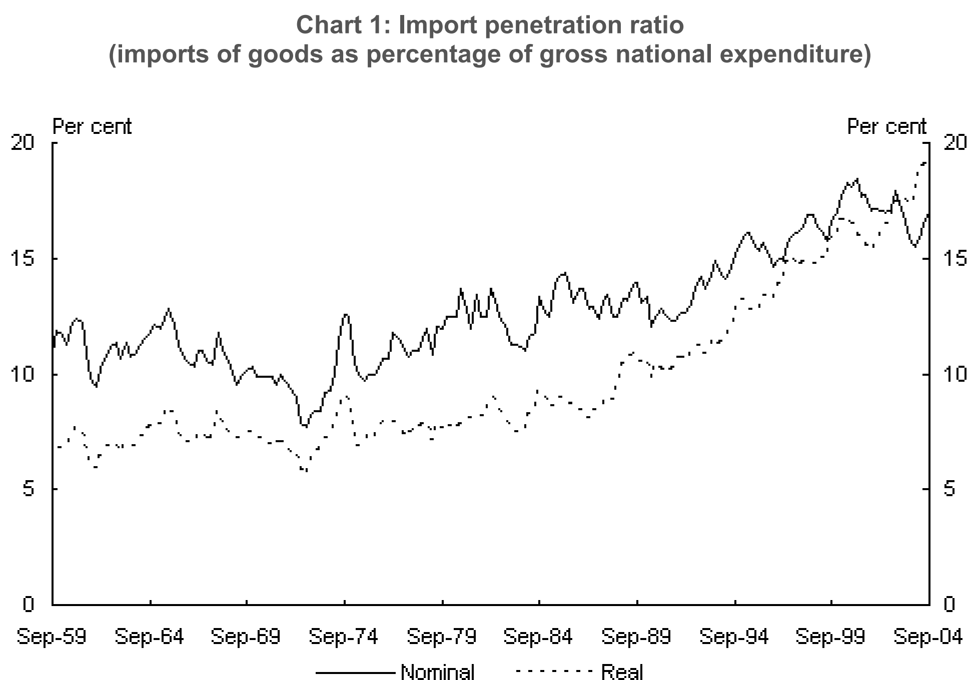
**Figure 3.12: Composition of imports of goods and services, percentage of total**




Source: ABS, *International Trade in Goods and Services* (Cat. No. 5368.0)

3.98 A recent Treasury study examined the question: 'Why have Australia's imports of goods increased so much?'[49] The study noted that imported goods increased their share of nominal domestic demand from about 11 per cent in the 1960s to about 17 per cent in 2004, as shown in Figure 3.13, below.

**Figure 3.13: Import penetration ratio (imports of goods as a % of GNE.**




Sources: Australian Bureau of Statistics, *Balance of Payments and International Investment Position*, cat. 5302.0 and *National Income Expenditure and Product*, cat. 5206.0.

3.99 Treasury identified rising incomes and falling relative prices for imports as the key factors behind increased imports. In the last 10 years growth in household spending exceeded growth in income, with the short-fall made up from a combination of decreasing savings and increasing debt.

3.100 The study concluded:

> Over the past decade the volume of imported goods grew by an average rate of 9 per cent a year, while real Gross National Expenditure grew by 4½ per cent. While a large part of the fast growth in imports can be explained by rising incomes and falling relative prices, other factors such as changes in tastes and specialisation have also played an important role.[50]

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[49] 'Why have Australia's imports of goods increased so much?', *Treasury Economic Roundup*, Summer 2004-05.

[50] 'Why have Australia's imports of goods increased so much?', *Treasury Economic Roundup,* Summer 2004-05, p. 43.

***Committee views***

3.101 The Committee concludes that there are a number of linkages between households and imports and the CAD, some more direct than others.

3.102 The import penetration ratio (Figure 3.11) suggests that imports represent a growing share of consumption. At least some of that would be at the expense of local manufacturing. That is an unfortunate fact of life in an increasingly globalised world. Communication and access are much easier today. Australian consumers demand access to an ever-wider range of products in quality and price, and that expectation can not be denied. The growth of imports would be of less concern if exports as a percentage of GDP were also growing, which is not the case, as shown in Figure 3.9.

## What are the risks of a persistently high CAD?

3.103 In the December 2004 quarter the CAD set a new record of 7.2% of GDP. A number of economists pointed out that this record was reached during a period when Australia's terms of trade were the highest in 30 years (which should have improved the trade balance), and when international interest rates have been low (which should have improved the income balance). One could reasonably have expected this to be a period of relatively low current account deficits, instead of a period when new records were being set.

3.104 The Treasury submission points out that the CAD has fluctuated between 3 and 6 per cent over the last 20 years, commenting:

> Fluctuations in the CAD are not a bad thing. They are a means by which Australia smoothes consumption in the face of income shocks, such as the Asian crisis. That is, the CAD, like the exchange rate, acts as a buffer or shock absorber between domestic demand and global developments.[51]

3.105 The Round Table discussed the question of whether a high level of CAD is necessarily bad, and the risks involved.

3.106 Dr Gruen saw the record deficit of 7.2% as a natural part of the wide fluctuations which have characterised the CAD over the last 20 years. He said:

> The Australian current account deficit has cycled between about two and seven per cent of GDP for 20 years now and has averaged just under five per cent of GDP for 20 years … in the last several years we have seen both the highest ratio to GDP and the lowest. My characterisation of the situation would be that we have seen quite big cycles in the current account but no obvious trend over that period. As I say, it has been around 5 percent - I

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[51] The Treasury, *Submission 13*, p. 2.

> think the average is 4.75 per cent - of GDP for 20 years and there have been quite big cycles around that.[52]

3.107 On the other hand, both Professor Garnaut and Dr Simes expressed concern at recent levels of the CAD. Professor Garnaut commented:

> Having a current account deficit of seven per cent of GDP does not prove that you have a big problem or crisis coming, but it should be a warning bell that you should look very carefully at what is generating it and at whether or not the things that are generating it are sustainable. It is an unusual figure for Australia and very unusual in the world, especially amongst developed countries … in earlier periods when it has gone up to that level it has been followed by quite severe adjustment problems. That does not prove that it is a problem now but it should get us thinking.[53]

3.108 Dr Simes described his misgivings about a CAD of recent proportions on several occasions during the Round Table, in the following terms:

> To me, a high current account deficit is a signal of something not quite right and it is something that … you should be cautious about.[54]
>
> …
>
> I think the size of the current account deficit is such that it is symptomatic of an underlying problem and should be a source for doing something about it. Again, because of the robustness of the financial markets and the rest of it, I have tried to say that there is no need to do anything quickly; it is more medium-term structural policies that we should be looking at.[55]
>
> …
>
> Why is a larger current account deficit a problem? Unless it is lifting the level of production - unless it is getting into investment and increasing the base - there is an issue for longer-term economic welfare for the next generation et cetera. To me it is symptomatic that we are not optimising our long-term economic welfare.[56]
>
> …
>
> There is no right and wrong level about the current account deficit in the first place. I am concerned that we have been at 4½ per cent of GDP for 20 years, and it looks like it is edging up. I would prefer it to be coming down … the current account deficit is too high today and looks like it is going to settle at an average level which is uncomfortably high over the next, say,

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52 *Proof Committee Hansard*, 15 August 2005, p. E2.

53 *Proof Committee Hansard*, 15 August 2005, p. E2.

54 *Proof Committee Hansard*, 15 August 2005, p. E5.

55 *Proof Committee Hansard*, 15 August 2005, p. E31.

56 *Proof Committee Hansard*, 15 August 2005, p. E33.

> five years or whatever, without policy adjusting it or doing something about it.[57]

3.109 Mr Conroy asserted that the high level of household debt in Australia posed three specific threats to the economy:

> The first is a recession induced by household demand evaporating to service debts. The second comes from the large external imbalance caused by the debt-induced current account deficit and spiralling foreign debt levels. The final risk to the economy originates from a misallocation of resources caused by the housing bubble and the consumer debt explosion reducing the long-term competitiveness of the Australian economy.[58]

3.110 Mr Conroy felt that the Australian economy is vulnerable not only to recession caused by a collapsing consumer demand but also to a change in the international sentiment regarding the Australian economy.[59] Professor Garnaut sounded a similar cautionary note: 'the views of international markets can change rather quickly.'[60]

3.111 The Round Table discussed various risks facing the private sector. Dr Gruen advised that in the aftermath of the Asian crisis Treasury has kept a close eye on the liabilities of the private sector. He said:

> There has been much more careful analysis by regulatory authorities of the sorts of liabilities in the private sector that could ultimately cause systemic problems. The lesson from the Asian crisis is that those are exactly the sorts of things you have to look at carefully. That is precisely what we have done … if one is going to have a consenting-adults view about the current account it is extremely important to take a view about possible shocks that could lead to systemic problems. In the Asian crisis case economists were not very good at predicting it. With the benefit of hindsight, we are much better at predicting things.[61]

3.112 The Round Table considered whether a sharp fall in house prices would impact on the ability of households to make their loan repayments. On this point, Dr Simes said:

> My view is that it is not only the fact that you have a large proportion of the population who are not in debt and who can support the others; it is also that the financial sector is attuned to providing credit et cetera in a fairly smooth way. Given that most of this debt is secured against a house and is

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57 *Proof Committee Hansard*, 15 August 2005, p. E33.

58 *Official Committee Hansard*, 16 May 2005, p. E13.

59 *Official Committee Hansard*, 16 May 2005, p. E13.

60 *Proof Committee Hansard*, 15 August 2005, p. E4. The Reserve Bank of Australia also sounds a cautionary note: '… the pre-conditions are in place for quite abrupt swings in sentiment and a disruptive snap-back in pricing.' RBA, *Financial Stability Review*, September 2005, p. 2.

61 *Proof Committee Hansard*, 15 August 2005, p. E14.

> being serviced by regular income, the real problem is only going to arise if you have a sharp lift in unemployment, not just if house prices fall.[62]

3.113 Both Dr Gruen and Mr Potter referred to a recent APRA[63] survey which found that the major banks could comfortably accommodate a 30 per cent slump in housing prices.

3.114 Dr Simes thought there is a low risk that interest rates would go to levels which would result in severe unemployment and have a major impact on the ability of households to service their debts. On the other hand, if foreign investment is withdrawn Dr Simes said that the exchange rate would respond appropriately to restore balance:

> If foreign investment is withdrawn, the adjustment will be through the exchange rate - that is, foreign money will be available at a price and it will be the exchange rate that does the buffering, as we saw in the Asian financial crisis, if you like. That will be manageable unless you have a system in the price-wage interactions where it is going to get into ongoing inflation, and that is hard to see in the current structure of the economy or for the next five years. You could not rule that coming back into play at some point, but it is a long way off.[64]

3.115 The Round Table discussed the adverse impact on local manufacturers of large fluctuations in the exchange rate within relatively short periods, as happened about 5 years ago, when the exchange rate went down to US$0.49 and then moved up to US$0.80. That kind of wide fluctuation puts considerable stress on local manufacturers as they endeavour to adjust to rapidly changing circumstances.

3.116 Dr Gruen agreed that this had put pressure on domestic manufacturers but said that a floating exchange rate is essential to sound economic management:

> The recent period … moving from US49c to something close to US80c, is not very usual. We have been in an extremely unusual circumstance of going from being viewed as the old economy in 2001 to this huge rise in the terms of trade, and the currency has gone with it. Given that the terms of trade are something that we get dealt largely by the rest of the world, allowing the currency to move with them may have sectoral implications that some people [manufacturers] would not like but, in terms of the stability of the overall economy, it is a huge advance on the last time we had a huge terms-of-trade rise like this, which was in 1973-74. The Australian economy did not cope well with that. We ended up with a big rise in inflation and a lot of other things as well. Nothing has only good

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62 *Proof Committee Hansard*, 15 August 2005, p. E10.

63 APRA – Australian Prudential Regulation Authority, which is part of the Treasury portfolio.

64 *Proof Committee Hansard*, 15 August 2005, p. E10.

> sides, but my judgement is that this is a much better way of allowing the economy to adjust than the alternatives.[65]

3.117 Dr Gruen reinforced the importance of a floating exchange rate by describing the important but adverse role fixed exchange rates played in the Asian financial crisis. He said:

> … it came as a rude shock to everyone when the Asian countries went into severe recessions. We discovered that they were running either fixed exchange rates against the US or effectively fixed exchange rates against the US. It was perhaps not realised that the financial health of most of the economies, not only the financial system but also the non-financial system, was inextricably tied to this exchange rate policy. In other words, once the currency depreciated significantly, the unhedged foreign borrowings in the companies and the financial system bankrupted large parts of the economy.[66]

3.118 Mr Conroy believes that manufacturing sector has suffered because interest rates have been kept artificially high so as to attract the funds required to meet excessive household consumption. This has pushed up the exchange rate, which has made imports relatively cheaper and hurt local manufacturers and exporters. He said:

> The reliance on capital inflow to fund consumer debt has adversely affected the manufacturing sector … it has crowded out direct foreign investment in manufacturing by forcing interest rates and exchange rates to be higher than would otherwise have been the case … it has allowed unsustainable growth in domestic demand resources which would otherwise have been allocated for manufacturing expansion … [and] Governments continue to believe that high and sustained economic growth can be achieved by letting the finance sector drive the economy … [they] no longer believe in the importance of manufacturing.[67]

### *What could improve the CAD?*

3.119 The Round Table discussed various ways in which the CAD could be brought back to lower levels.

3.120 Professor Garnaut believes the CAD will eventually self-correct, but questioned the economic and social cost of leaving such adjustment solely to market forces. He commented:

> There is a sense in which there cannot be a long-term current account deficit problem because in its nature it is self-correcting. Indonesia and

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65 *Proof Committee Hansard*, 15 August 2005, p. E8.

66 *Proof Committee Hansard*, 15 August 2005, p. E13.

67 *Official Committee Hansard*, 16 May 2005, p. E14.

> Thailand had current account deficits in 1996 that some people thought were worrying. They had large current account surpluses by late 1998 and 1999, so there is a sense in which there was no current account deficit problem because it was self-correcting. The problem was the consequences of the adjustment that the economy had to go through.
>
> So the issue we are talking about is not really a problem of whether the current account deficit will adjust or whether in the end whatever deficit is there will be financed - by definition it will be. The question is: what will the process of adjustment be and what stress will that place on government budgets, on unemployment and on economic activity - or, to put it another way, will it give us a recession like similar adjustments have in the past?
>
> So the questions in the end become ones of vulnerability to circumstances changing and forcing adjustment and of our capacity to handle without excessive pain the adjustments that will be necessary.[68]

3.121 There was general agreement that the cooling-off of the housing boom would diminish the 'wealth effect' on households which, coupled with rising interest rates (and, more recently, rising fuel prices) would in turn reduce household spending and borrowing. Dr Gruen expressed it as follows:

> Their [Reserve Bank] latest estimate … is that in the 18 months to the December quarter 2003 house prices in Australia went up 29 per cent. Over the last 18 months they went up by exactly nothing …the consequences of that for the savings and investment balance of the household are going to be very substantial. So I think there are self-correcting forces in play in the Australian economy which should move us in the direction of smaller current account deficits.[69]

3.122 Professor Garnaut supported this assessment:

> You cannot have your households dis-saving forever, with that being balanced by ever-increasing asset values - in this case, bubble housing values. We are going through an adjustment now, as the housing boom has reached a plateau … Over time, one would expect that to significantly bring down consumption and raise saving rates.[70]

3.123 Although Dr Simes considered the high level of the CAD to be of concern, he does not see a crisis situation yet. He said that there are several reasons why the level of the CAD may come back to a lower level—for example, through a slowdown in economic demand and activity induced by a fall in the terms of trade; or a reduction in house prices; or if foreigners withdraw capital leading to a fall in the exchange rate. He expressed the belief that the financial sector is strong enough to absorb such adjustments. He concluded:

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68 *Proof Committee Hansard*, 15 August 2005, p. E10.

69 *Proof Committee Hansard,* 15 August 2005, p. E9.

70 *Proof Committee Hansard*, 15 August 2005, p. E4.

> The current account is an issue and something we should be acting to address, but we can do it over the medium term, and we should be looking at medium-term policy changes either related to savings or to exports.[71]

3.124 An increase in national savings would enable more of Australia's investment to be financed from domestic savings rather than by borrowing overseas, thus improving the income balance of the current account. Additionally, if exports grow faster than imports, the trade balance is improved. Enhancing domestic savings and lifting export growth helps the current account.

3.125 Dr Simes suggested looking at 'superannuation and the like',[72] and recommended raising the superannuation contribution rate from 9 to 15 percent.[73]

3.126 Mr Pearson commented on the impediments that limit the amount of superannuation people are prepared to take out. He felt that, before increasing the contribution rate, more should be done to remove the impediments to superannuation such as the taxes and the residual benefit limits.[74]

3.127 Mr Potter disagreed and argued that targeting superannuation would not be an appropriate policy response to address the level of CAD. He said:

> We think that super policy should be driven on its own merits, not because of the effect it has on national savings. I will separate it into two issues. You can either have the government investing in people's super - that is one possibility - or increase people's compulsory contributions. On the first one, if the government puts more money into people's super then that actually reduces the fiscal balance, so you may end up with no benefit to national savings. You might have an increase in the amount in people's super accounts, but a reduction in the government deficit and you would only be a little bit better off. On the other hand, you could, for example, increase the compulsory component of superannuation. We do not think that is such a good idea because, in a sense, super is like a payroll tax. I think the last thing that businesses want is to have is an increase in payroll taxes.[75]

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71 *Proof Committee Hansard*, 15 August 2005, p. E6.

72 *Proof Committee Hansard*, 15 August 2005, p. E15.

73 *Proof Committee Hansard*, 15 August 2005, p. E27.

74 *Proof Committee Hansard*, 15 August 2005, p. E27.

75 *Proof Committee Hansard*, 15 August 2005, p. 17.

### *Are the self-correcting mechanisms working?*

3.128 A recent article in *The Economist* pointed out that a number of self-correcting mechanisms appeared to have 'jammed' and were no longer working as they were supposed to according to conventional economic theory. The article gave three examples, based on the USA whose CAD is forecast to exceed 6 percent of GDP in 2005 (i.e. a deficit of over US$800 billion).

> Firstly, in theory a rapidly rising CAD should cause investors to demand higher interest rates to compensate them for the increased risk of currency depreciation. Dearer money then helps to dampen domestic spending and thus trim the external deficit. This is what happened when America's CAD exploded in the first half of the 1980s. Real bond yields rose, cooling domestic demand. Along with the cheaper dollar, this helped to reduce the deficit. This time, however, the adjustment mechanism has jammed: real American bond yields have fallen not risen over the past few years, partly because Asian central banks have been eager to buy US Treasury bonds to prevent their currencies from rising. So long as low bond yields continue to support America's housing bubble and hence strong consumer spending, they will block any significant reduction in the CAD.
>
> Secondly, in the past a rapid rise in consumer borrowing and spending would cause a central bank to push up interest rates to curb inflation. Today, however, inflation is held down by cheap goods from China and other low-wage economies, and inflationary expectations are well anchored thanks to the credibility of central banks. As a result, central banks have been able to hold interest rates below the growth in nominal GDP (the income from which debts must be serviced) for a prolonged period. This has, in effect, lifted any constraint on credit growth, allowing a bigger build-up of private sector debt.
>
> Thirdly, a broken circuit is apparent between interest rates and growth. Sluggish economies with low inflation require lower real interest rates than economic sprinters. Yet despite its faster growth, America's real bond yields are lower than Japan's and about the same as in the euro area. Yields are arguably too low for America but too high for Germany and Japan, causing the growth gap to persist.[76]

3.129 The article describes interest rates and bond yields as the traffic lights of the global economy: they tell economies when to go and when to stop. The market would punish economies where governments or households borrow recklessly with higher bond yields, prompting them to tighten their belts. Prudent economies would be rewarded with lower real rates. But today financial markets are doing a poor job as economic watchdogs: in particular, America's profligacy is being subsidised rather than punished.

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[76] 'Traffic lights on the blink?', *The Economist*, 20 August 2005, p. 49.

3.130 In a closed economy, according to the article, if a government increases its budget deficit it must pay higher interest rates to persuade domestic investors to hold more bonds. But if it can tap global savings, it can borrow more cheaply because a smaller rise in rates is needed to attract the required funds. Even so, an efficient international capital market is supposed to ensure that capital is allocated to the most productive use. Yet much of the recent inflow of foreign money into America is not financing productive investment, but a housing bubble and a consumer binge.

3.131 A possible explanation is that, with interest rates low everywhere, investors are hungry for any sort of yield. This has made them more willing to buy high-yield bonds, and has pushed down the spread that riskier borrowers must pay compared with safer borrowers. When financial conditions tighten, investors are sure to become more discriminating again.

3.132 The article concludes by warning that when the inevitable correction comes, it will be all the more painful because of the large imbalances which have developed.

3.133 The Committee acknowledges that the focus of the article in *The Economist* was the USA, but notes the many apparent similarities with the situation in Australia, with its big increase in household consumption and debt and the related housing boom of 2002-04.

3.134 A study by the US Federal Reserve Board in 2000 of a number of countries found that self-correcting mechanisms should kick in when a CAD reaches about 5 per cent of GDP:

> A typical adjustment occurs after the current account deficit has grown for about four years and reaches about 5 percent of GDP. The results from previous episodes suggest that reversals involve a real depreciation of 10 to 20 per cent and slow real income growth for a period of about three years. Real export growth, declining investment, and an eventual levelling off in the net international investment position and in the budget deficit-GDP ratio are also likely to be part of the adjustment.[77]

3.135 A speech in May 2004 by Edward Gramlich, Governor of the US Federal Reserve Board, focused on the sustainability of rising trade and budget deficits.[78] These issues are now attracting much more detailed analysis and debate in the USA, as they should be in Australia.

3.136 Australia has now had a CAD of over 5 per cent of GDP for 11 consecutive quarters, and the expected correction in the exchange rate has not taken place. Could this be a practical example of the 'jamming' referred to by *The Economist* (above)?

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77 CL Freund, 'Current account adjustment in industrialised countries', *International Finance Discussion Papers, No. 692, Federal Reserve System*, December 2000, pp. 17-18.

78 *Budget and trade deficits: linked, both worrisome in the long run, but not twins*, Speech by E M Gramlich, Governor Federal Reserve Board, 14 May 2004.

3.137 In another warning that global imbalances need watching, the International Monetary Fund's World Economic Outlook bulletin released in September 2005 warns that the USA's growing trade and budget deficits are unsustainable and will put great stress on global financial markets unless action is taken to bring them back into line.[79]

3.138 The Governor of the Reserve Bank of Australia, Mr I J Macfarlane, believes that there are some early signs of a return to normality, even if they are small and the process likely to be long. He points to the policy of the US Federal Reserve to gradually move up interest rates and China's abandonment of its fixed parity to the US dollar as key initiatives to support his thesis.[80]

### *Is there a need for policy changes?*

3.139 The Round Table discussed the need for further reforms to enable the economy to readily respond to adjustments resulting from the CAD's fluctuations. They identified two areas deserving additional attention - reforms to raise productivity and initiatives to lift exports.

3.140 Professor Garnaut commented:

> There is a sense in which this set of circumstances tells us that we are living beyond our sustainable means. That might not be a terrible thing if we are given the chance to adjust gradually and pull in our belts a bit - the household sector spends a bit less, gradually, over a number of years - so we haul things back into a sustainable shape. But, one way or another, we have to reduce the rate of growth of expenditure relative to growth in the productive capacity of the economy. The more we can raise average productivity through productivity-raising reform and the issues that have been raised about better utilising underutilised labour in our economy - and there is a lot of it - and the more we can remove barriers to skills training and so on, the less we have to reduce our living standards to make the adjustment.[81]

3.141 He continued:

> …a large current account deficit requires, amongst other things, an adjustment over time. It has to involve some relative shift of resources from domestic sectors of the economy to international sectors, producing exports or import-competing products. The more successful we are in raising productivity, removing barriers to efficient performance of our potential

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79 IMF World Economic Outlook, September 2005. Some economists have estimated that it would take a real depreciation of 30% in the US$ to eliminate the USA's current account deficit, WEO, Chapter 1, p. 72.

80 *What are the global imbalances?* Speech by Mr Macfarlane to the Economic Society of Australia on 28 September 2005.

81 *Proof Committee Hansard*, 15 August 2005, p. E26.

> export industries, the less the external adjustment has to take the form of a crude reduction in living standards. I think that is the link between productivity-raising reform in all its forms and the current account deficit.[82]

3.142 Dr Simes agreed with the desirability for productivity-raising reform, although he cautioned that the impact on the current account of such reforms is unclear:

> This is related to what Ross [Garnaut] is saying. What he is saying is that, the more the benefits from microeconomic reform or whatever, the less pain we have with the adjustment. My understanding of the empirical literature, though, is that we have not seen a direct causation shown between microeconomic reform as such and the current account. You would hope that, given some of the points that Ross is raising, that would be there. We want microeconomic reform, more productivity growth et cetera in any case.[83]

3.143 In response Dr Gruen said that productivity-enhancing reforms should be undertaken for their own direct benefits (such as enhancing productivity, raising living standards and increasing the flexibility of the economy) rather than for any indirect impacts they may have on the current account. He pointed out that if such reforms make Australia appear an even better place to invest, they could result in a higher CAD.[84]

3.144 Dr Simes (and Prof Garnaut) believes that fiscal policy should be such that in periods of high revenue (e.g. due to high terms of trade) the Government should budget for larger-than-normal surpluses. These surpluses should be saved for use in years when revenue falls, or used to enhance productivity in areas of national importance such as education and training.

3.145 Dr Gruen responded that 'the general government sector in Australia has been in surplus for eight years in a row, with an average surplus of about one per cent of GDP. That is a significantly tight fiscal policy…'[85]

3.146 Professor Garnaut agreed that the Government's overall fiscal policy had been appropriate, but added:

> I think we would be less vulnerable to a large deterioration in the terms of trade if, in the early period after a big improvement in the terms of trade, we ran a bigger than average surplus and then ran that down in tax cuts or other productive ways when the terms of trade retreated, or when we had realised that the China boom is not a short-term boost to minerals and energy prices but is there forever. In that case, once we know that - and we do not know it

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82 *Proof Committee Hansard*, 15 August 2005, p. E26.

83 *Proof Committee Hansard*, 15 August 2005, p. E26.

84 *Proof Committee Hansard*, 15 August 2005, p. E31.

85 *Proof Committee Hansard*, 15 August 2005, p. E28.

> yet - we can absorb it then into our permanently higher expenditure levels. But the prudent thing is to run larger surpluses when you have boosts in revenue that are temporary or that may turn out to be temporary.[86]

3.147 Dr Gruen questioned the suggestion that proactive policy changes are required to address the high CAD. He said:

> I think one has to be encouraged by the market's view of Australia in a range of circumstances. There was the Asian crisis, when you might have imagined that a country that was running a large current account deficit would be treated with suspicion. We experienced precisely the opposite and were treated as a safe haven. There was the period in 2000 when all things 'new economy' were regarded as the bee's knees and we were very much out of favour. The currency fell, but there was no sign of difficulty in funding the current account. Is it possible at some point in the future that the market will lose confidence in us? I guess you would have to say it is possible, but the experience that we have suggests that, in a range of circumstances where you might have wondered how we would go, we have actually done fine. The adjustment mechanisms which you would hope would help - namely, the exchange rate falling and allowing an improving export position - have done what you would have wanted.[87]

3.148 Mr Conroy proposed seven initiatives to move the economy from one which is driven by consumer debt to one based on exports of knowledge-intensive manufactured goods:

> … prudent economic management and solid economic fundamentals; acceleration of the growth of business investment in R&D; increased greenfield foreign direct investment; greater import replacement; an increase in exporters and the extension of the capacity of existing exporters; investment in supporting physical, social, R&D and environmental expenditure and infrastructure; and increased levels of private equity investment, especially venture capital.[88]

### *Committee views*

3.149 In theory, when the CAD gets too high self-correcting market forces are triggered. Interest rates will tend to rise (slowing economic growth); the exchange rate will tend to fall (making imports more expensive and exports cheaper); the trade balance will improve; and as a result the CAD will improve.

3.150 In practice, however, other factors can delay or inhibit these market forces. The article in *The Economist* referred to earlier describes the apparent 'jamming' of

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86 *Proof Committee Hansard*, 15 August 2005, p. E29.

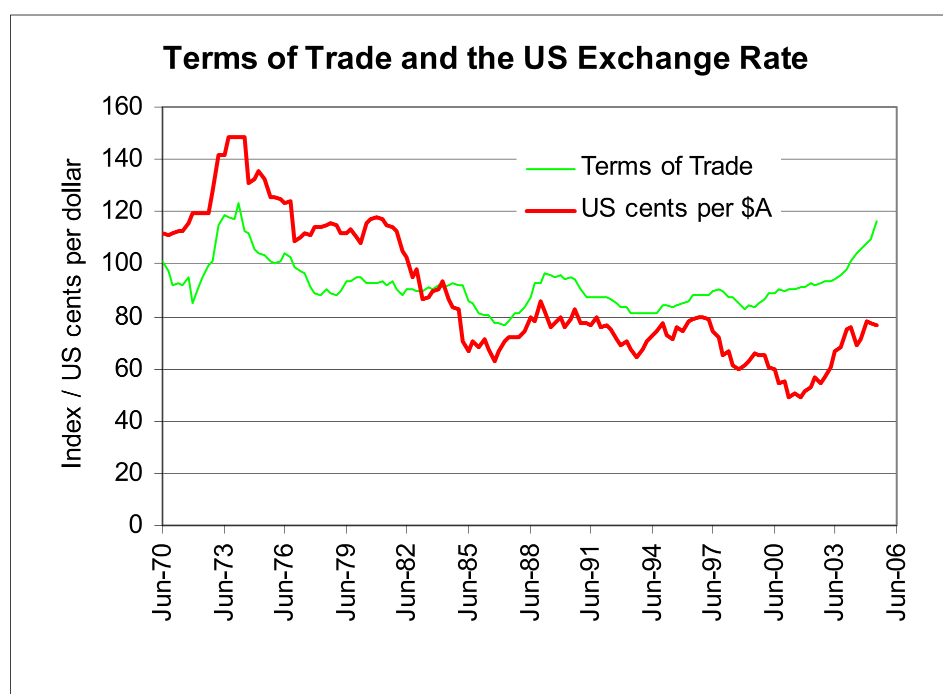
87 *Proof Committee Hansard*, 15 August 2005, p. E28.

88 *Official Committee Hansard*, 16 May 2005, p. E14.

self-correcting mechanisms. That seems to have been Australia's case recently - despite recording a CAD of over 5 percent of GDP for eleven consecutive quarters the exchange rate continues at a relatively high level, in response to high terms of trade and a continuing large inflow of money.

3.151 Figure 3.14 shows how the A$ / US$ exchange rate has moved relative to the terms of trade. The two graph lines have tended to be in rough synch, until recent years. Could this widening gap indicate the opposing forces of the terms of trade and the CAD at work?

**Figure 3.14: Comparison of the terms of trade and the A$ / US$ exchange rate.**




Sources: RBA, *Daily Statistical Release* for exchange rates; ABS, *Balance of Payments and International Investment Position*, Cat. 5302.0 for terms of trade.

3.152 The CAD has retreated, at least temporarily, from its record level of 7.2 per cent in the December 2004 quarter, due mainly to higher export receipts from high export prices of minerals and energy commodities. Export volumes are also picking up. So the trade balance should show some improvement in coming quarters. However, the income balance is expected to deteriorate as net interest payments, and net dividends and reinvested earnings continue to rise reflecting higher international interest rates, and high corporate profits in Australia.

3.153 The Round Table discussed, briefly, the need for greater domestic savings and faster export growth as ways to improve the current account. Facilitating superannuation was identified as a means of increasing savings, but there was no time to consider other possible alternatives.

3.154 The Committee noted recent Government policy initiatives which will enhance superannuation - specifically, the removal of the superannuation surcharge and the extension of the co-contribution scheme.

3.155 The Committee believes that these changes represent a good start, and urges the Government to take further initiatives to increase the attractiveness of superannuation as a preferred form of savings.

3.156 The Committee received a range of opinions as to the risk posed by a persistently high level of CAD. Treasury said that the high level was part of the normal fluctuations in the CAD and as long as we could readily borrow the required funds, it did not represent a major problem. On the other hand, Professor Garnaut and Dr Simes sounded a note of caution and concern.

3.157 After reviewing the evidence presented to this Inquiry, the Committee has formed the opinion that Australia's large and persistent current account deficits may be an indicator of underlying imbalances in the economy. The precise level of risk they pose to Australia's future economic well-being can be debated, but there seems no doubt that they do present a risk. This risk needs to be closely monitored, but more than that the Committee believes that it is time for the Government to take proactive action.

3.158 The Committee is particularly concerned at the trend towards a higher average level of CAD, perhaps to around 6 percent of GDP. The Committee accepts that Australia will continue to run deficits in its current account, but feels that a deficit of around 2 per cent of GDP would make us much less vulnerable than one of 6 per cent.

3.159 The Committee would be much more comfortable if the current trend towards higher average deficits was reversed, and believes that the Government should introduce policies which will lead to a lowering in the average CAD over the medium-to-long term.

3.160 The Committee would like to see more debate and discussion in Australia on this important topic. The Treasury is the obvious government agency to take the lead in this area.

3.161 While the current account is discussed in Budget Statements and similar documents, there seems to be infrequent in-depth analyses produced by Treasury on this important subject. An examination of the publications on the Treasury website indicated that the last in-depth research on aspects of the current account was published in the Centenary Edition of Treasury's quarterly Economic Roundup bulletin, in May 2001.[89]

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[89] Treasury website www.treasury.gov.au accessed on 12 September 2005. Treasury's submission to this Inquiry appeared in the June 2005 edition of *Economic Roundup*. The article in the May 2001 edition of *Economic Roundup* was titled 'The net income deficit over the past two decades'.

3.162 Treasury's Economic Roundup bulletin of August 2004 contained an article titled *Might the United States continue to run large current account deficits?* That is the type of analysis the Committee would like to see more of, but focused on Australia's own current account situation and the risks it might represent to the economy.

3.163 In fact, the Committee suggests that an in-depth analysis of developments in Australia's current account be an annual feature article in the Economic Roundup bulletin. Questions which should be analysed on a regular basis include:

- What would it mean for Australia if the CAD averages around 6% of GDP for the next few years?
- Is there a level at which the CAD becomes unsustainable?
- What are the options for improving the long-term average of the CAD?
- What lessons can we learn from other countries such as Canada?
- What would be the effects on the Australian economy of possible shocks such as a terrorist attack or an energy crisis?
- What would the implications for the economy be of large and unexpected falls in business and/or consumer confidence, and what factors could trigger such falls?
- What would be the impact of a sharp downturn in international demand for Australia's exports of minerals and energy?

3.164 The Treasury should also take more opportunities to publicly discuss issues related to developments in Australia's current account.[90] The Committee recognises that Treasury's task in managing the economy is not an easy one, but the precautionary principle demands that it fully considers a wide range of possible scenarios.

**Recommendation 3**

**The Committee recommends that the Government introduces policies designed to bring about an improvement in the medium-to-long term average of the current account deficit, including improving domestic savings and increasing the diversity and international competitiveness of the export sector**

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[90] For example, Treasury presented a paper to the ABE Forecasting Conference on 14 December 2004 titled 'Australia's medium-term challenges'. Key challenges for Australia identified in the paper include labour productivity, household debt, and exports. The paper also contained a discussion of the USA's current account deficit - but curiously not our own.

# Chapter 4

# Household debt in Australia

> *I suspect that a significant number of households have taken on a debt level which makes sense in the good times, but does not take into account the fact that bad times will inevitably occur at some time or the other.*[1]

## Introduction

4.1 A significant cultural change seems to have taken place in the attitude of many Australians towards debt. Twenty years ago Australian households averaged about $50 in debt for every $100 of income. That figure has now risen to about $150 in debt for every $100 of income.

4.2 Similar rises in debt to income ratios have occurred in other countries, particularly in the last decade, although the rise in Australia has been more rapid than in most other countries. In line with this increase in the household debt to income ratio, the total amount lent to persons by banks has also risen dramatically, from $92.4 billion in 1990, to $579.1 billion in 2005.[2]

4.3 From having one of the most conservative approaches to debt in the OECD, Australians are now amongst the heaviest borrowers and seem to have accepted much higher debt levels as part of life in the new millennium.

4.4 The large rises in household debt in this country have aroused concern and provoked comment both nationally and internationally, for example in the internationally renowned *The Economist*:

> The profligacy of American and British households is legendary, but Australians have been even more reckless…there are now concerns that unsustainable rates of borrowing will sooner or later end in tears.[3]

4.5 Many of the statistics and graphs used in this chapter are drawn from material provided to the Committee by the Treasury and by the ANZ Bank. Other material was derived from statistics compiled by the Department of Parliamentary Services Parliamentary Library Statistics Group or published by the Reserve Bank of Australia (RBA) and the Australian Bureau of Statistics (ABS). The Committee records its thanks for the assistance provided.

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1 RBA, *Do Australian households borrow too much?,* p. 7.

2 RBA, *Bank lending by sector*, Table D05 http://www.rba.gov.au/Statistics/Bulletin/D05hist.xls

3 'Living in never-never land', *The Economist*, 9 January 2003.

## The growth of household debt

4.6 Table 4.1 shows the size of household debt or liabilities in Australia and how it has grown.

**Table 4.1: Household liabilities and assets, $ billion**

| Quarter | Liabilities $ b | Assets $b | | | Liabilities as % of assets % | Liabilities as % of GDP % | Liabilities as % of gross household disposable income, % |
|---|---|---|---|---|---|---|---|
| | | Non-Financial | Financial | Total | | | |
| Jun-90 | 187 | 873 | 500 | 1373 | 13.6 | 48.6 | 70.6 |
| Jun-95 | 267 | 1114 | 705 | 1819 | 14.7 | 56.8 | 82.4 |
| Jun-00 | 473 | 1642 | 1117 | 2759 | 17.1 | 75.8 | 114.6 |
| Jun-01 | 515 | 1793 | 1219 | 3012 | 17.1 | 77.1 | 114.1 |
| Jun-02 | 596 | 2106 | 1269 | 3375 | 17.7 | 83.6 | 126.5 |
| Jun-03 | 685 | 2400 | 1315 | 3715 | 18.4 | 90.4 | 140.9 |
| Jun-04 | 796 | 2767 | 1477 | 4244 | 18.8 | 98.0 | 153.7 |
| Mar-05 | 861 | 2912 | 1631 | 4543 | 18.9 | 99.7 | 157.7 |

Source: RBA Bulletin, Table B.20, based on ABS, *Financial Accounts* (Cat. No. 5232.0) - for household liabilities; and ABS, *National Income Expenditure and Product* (Cat. No. 5206.0) - for gross household disposable income.

Note: 'Non-financial assets' comprise consumer durables and dwellings – dwellings represented 95% of total non-financial assets for the March 2005 quarter; 'Financial assets' include both households and unincorporated enterprises and cover bank deposits, shares and superannuation.

4.7 Bank lending to households over the last fifteen years has grown a faster rate than the economy. Total bank lending to households grew from 24 per cent of GDP in 1990 to 67 per cent in 2005. It should be noted that this statistic understates total lending as it does not include non-bank sources of finance such as credit unions and non-conforming lenders.

4.8 Based on bank lending statistics, the major part of debt held by Australian households, 85 per cent, is made up of mortgages for housing. Fixed term loans make up a further 6 per cent, and revolving loans (which include credit and charge card debt and lines of credit) the remaining 9 per cent.

4.9 Housing mortgages may be further broken down between owner-occupiers and investors. Borrowing for investment purposes currently comprises 34 per cent of borrowings for housing.

4.10 Credit card debt totalled $31.4 billion as at June 2005, representing 58.5 per cent of revolving loans and 5.4 per cent of total household debt. Credit card debt has risen from $4.1 billion (June 1990) to $31.4 billion (June 2005). 4

4.11 Growth in fixed term loans (for example, unsecured personal loans) has been more modest however, increasing from $19 billion to $33.5 billion between 1990 and 2005. The ANZ submission points out that the rate of growth of personal borrowing has almost halved, from an annualised rate of 22% in the December 2003 quarter to 12% in the December 2004 quarter.[5]

4.12 The Reserve Bank of Australia has published the following figures for bank lending (Table 4.2) which show that while borrowing has continued to grow, the rate of growth has slowed in the last year.

**Table 4.2: Bank lending to persons, June 1999 to 2005, $billion[6]**

| Month/Year | Housing | | Other Personal | | Total $billion (and change over previous year) |
|---|---|---|---|---|---|
| | Owner-occupiers | Investors | Fixed loans | Revolving loans | |
| June 1999 | 153.1 | 60.7 | 21.2 | 21.4 | 256.3 |
| June 2000 | 169.7 | 75.7 | 22.5 | 26.7 | 294.6 (+15%) |
| June 2001 | 194.0 | 86.1 | 19.6 | 27.2 | 326.9 (+11%) |
| June 2002 | 220.5 | 96.9 | 26.7 | 31.4 | 375.5 (+15%) |
| June 2003 | 254.2 | 123.3 | 28.8 | 37.9 | 444.3 (+18%) |
| June 2004 | 288.6 | 151.9 | 31.6 | 45.4 | 517.4 (+17%) |
| June 2005 | 324.0 | 167.9 | 33.5 | 53.7 | 579.1 (+12%) |

Source: RBA Bulletin, August 2005, Table D.5.

4 Derived from Reserve Bank of Australia, *Credit and Charge Card Statistics*, Table C1, http://www.rba.gov.au/Statistics/AlphaListing/alpha_listing_c.html

5 ANZ, *Submission 17*, p. 7.

6 This table shows bank lending only and does not include lending by non-bank lending institutions.

## Factors contributing to the rise in household debt

4.13 Most of the evidence available to the Committee focussed on housing related debt and credit card debt. Contributors to the inquiry and other commentators broadly agree on the main causes of the rise in household debt, although opinions differ about significance of the various contributing factors. The primary factors that have resulted in much higher household debt levels include:

- Freeing up of the financial markets, which meant credit became much more readily available;
- A prolonged period of low inflation and low interest rates gave consumers a feeling of confidence in the economy;
- Increased competition in lending, more advertising and promotion;
- A much wider range of products from lenders, including lines of credit and interest-only loans;
- The stockmarket boom in the mid-to-late 1990's followed by the real estate boom and the ability of consumers to borrow for investment purposes;
- The growing acceptance of the concept of debt used for investment as 'good debt', actively promoted by financial advisers promoting wealth creation strategies based on investment in equities and property;
- Increasing financial literacy and the realisation of the baby boomer generation that it would have to take more responsibility for funding a comfortable retirement;
- Rising asset values, especially in residential real estate, which gave home owners a feeling of increased wealth (so-called 'wealth effect'), and the ability to unlock that wealth through new financial products such as loans based on home equity;
- A sustained period of economic growth, low inflation, low interest rates, and falling unemployment.

4.14 A detailed discussion of these various influences is contained in Appendix 5.

## Distribution of debt across households

4.15 Debt is distributed unevenly across households. Treasury pointed out that only a third of households have a mortgage, and that the debt to income ratios in these households will be higher than the average figure.[7]

4.16 A study conducted by University of Melbourne researchers[8] found that debt levels do vary significantly. The study revealed that about a third of households have

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[7] The Treasury, *Submission 13*, p. 7.

no debt, and almost a quarter have debts equivalent to less than half a year's income. However, for 9 per cent of households, liabilities exceed four times annual income.

4.17 Treasury suggested that there is a strong relationship between income and debt, those with higher incomes holding most of the debt and being well placed to repay it. The University of Melbourne study confirms this relationship, showing that most household debt is held by income rich and asset rich households.

4.18 Using assets as a measure of wealth, 72 per cent of all debt is held by the wealthiest 30 per cent of households, and 42 per cent of debt by the wealthiest 10 per cent. The 20 per cent of households that are the least wealthy in terms of the assets they have account for just 6 per cent of household debt. The survey found similar results when income is used as the measure of wealth. Table 4.3 shows the distribution of assets and debt among the Australian population. This table is divided according to net worth (i.e.: the value of all assets and savings) and net income.

**Table 4.3: The distribution of household wealth and income by percentile**

| Percentile | Sorted by net worth | | Sorted by net income | |
|---|---|---|---|---|
| | Assets | Debts | Assets | Debts |
| 1-10 | 0 | 0 | 5 | 2 |
| 11-20 | 1 | 0 | 5 | 2 |
| 21-30 | 2 | 1 | 5 | 3 |
| 31-40 | 4 | 3 | 7 | 5 |
| 41-50 | 5 | 5 | 7 | 7 |
| 51-60 | 7 | 7 | 9 | 8 |
| 61-70 | 9 | 9 | 10 | 11 |
| 71-80 | 12 | 13 | 13 | 16 |
| 81-90 | 18 | 18 | 15 | 17 |
| 91-100 | 42 | 45 | 25 | 27 |
| TOTAL | 100 | 100 | 100 | 100 |

Source: Table is an extract from Table 5, p14 of *Income, wealth and joblessness: insights from the HILDA survey*, a paper by B. Headey and M. Wooden of the University of Melbourne presented to the 2005 Melbourne Institute Economic and Social Outlook Conference, 31 March – 1 April 2005.

[8] *Income, wealth and joblessness: insights from the HILDA survey*, a paper by B. Headey and M Wooden of the University of Melbourne, presented to the 2005 Melbourne Institute Economic and Social Outlook Conference, 31 March – 1 April 2005.

4.19 An analysis of the same HILDA data used in the University of Melbourne study conducted by the Economic Group of the RBA somewhat unsurprisingly confirmed these findings.[9] This study showed that households that are most highly leveraged (i.e.: have the highest debts-to-assets ratio) are those most able to bear the debt - mid-life households with high income.

4.20 This study also found that those households living in areas described as 'least vulnerable to reversals in housing prices, the outer suburbs and non-metropolitan regions that have experienced relatively smaller gains in recent years' and households that are negatively geared on investment property tend to be more highly leveraged.

4.21 The study found that while young households in general are less likely to be homeowners, those who do have mortgages are likely to have particularly high leverage.

4.22 However, the study does appear to confirm that relatively few households are leveraged at a level considered to be 'high'. The study estimated that 11.4 per cent of households with housing loans (less than 4 per cent of all households) had a ratio that was 'high' – that is, exceeded 80 per cent - and less than 3 per cent had negative equity in their homes.[10]

## Household debt indicators

4.23 How are households coping with increases in debt levels? A number of ratios provide a picture of the impact of debt on households. They include: household saving ratio; debt to income ratio; interest-to-income ratio; and the household gearing ratio.

### *Household savings ratio*

4.24 The household savings ratio is calculated as a percentage of household savings to household income. The trend for Australian households over the last 20 years has been one of a diminishing rate of savings and rising consumption, to the extent that Australian households have now entered a period of dis-saving as shown in Figure 4.1.

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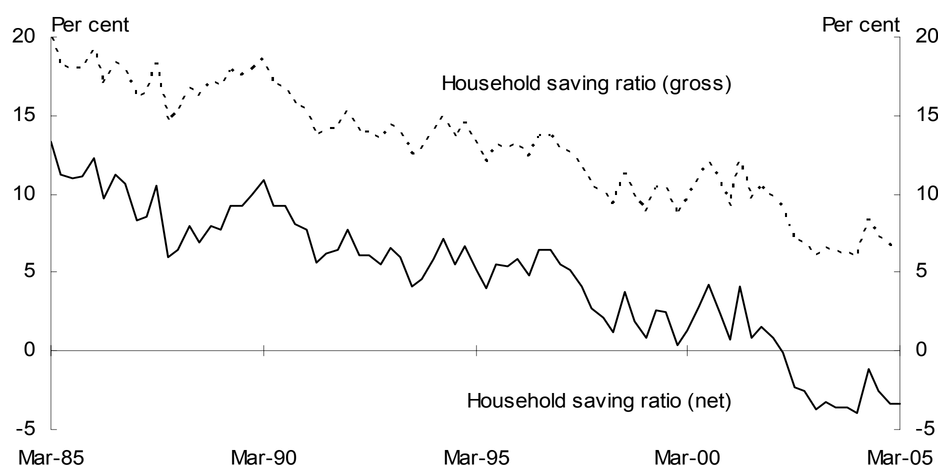
9 RBA Economic Group, *Housing Leverage in Australia*, Luci Ellis, Jeremy Lawson and Laura Roberts-Thomson, July 2003.

10 RBA Economic Group, *Housing Leverage in Australia*, Luci Ellis, Jeremy Lawson and Laura Roberts-Thomson, July 2003, p. 8.

**Figure 4.1: Savings ratio of Australian households**

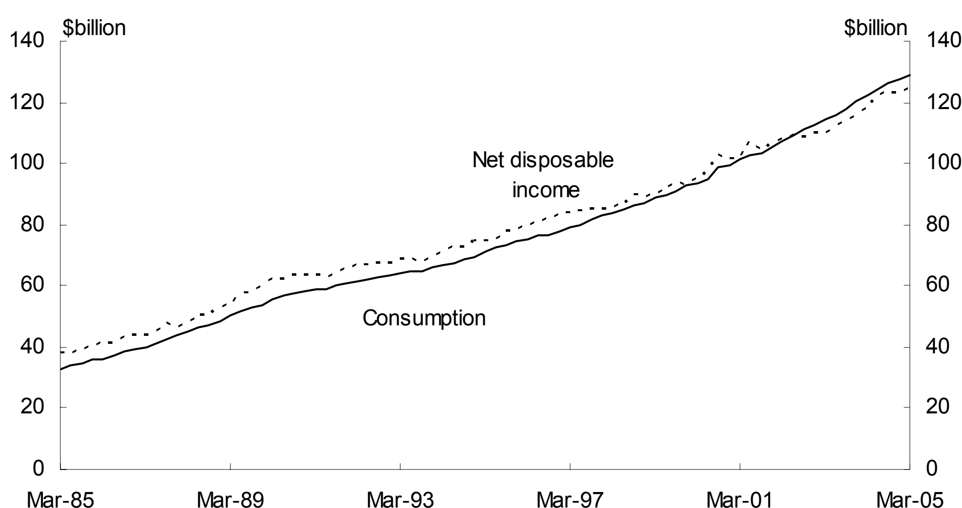



Source: Australian Bureau of Statistics cat. no. 5206.0

4.25 Treasury advised the Committee that although the household savings ratio has a number of limitations 'the broad conclusion that households are saving proportionately less of income now than in the past is likely to be correct'. [11]

4.26 This trend is also clear when consumption and income are compared, as shown in Figure 4.2:

**Figure 4.2: Household consumption and income**




### *Debt-to-income ratio*

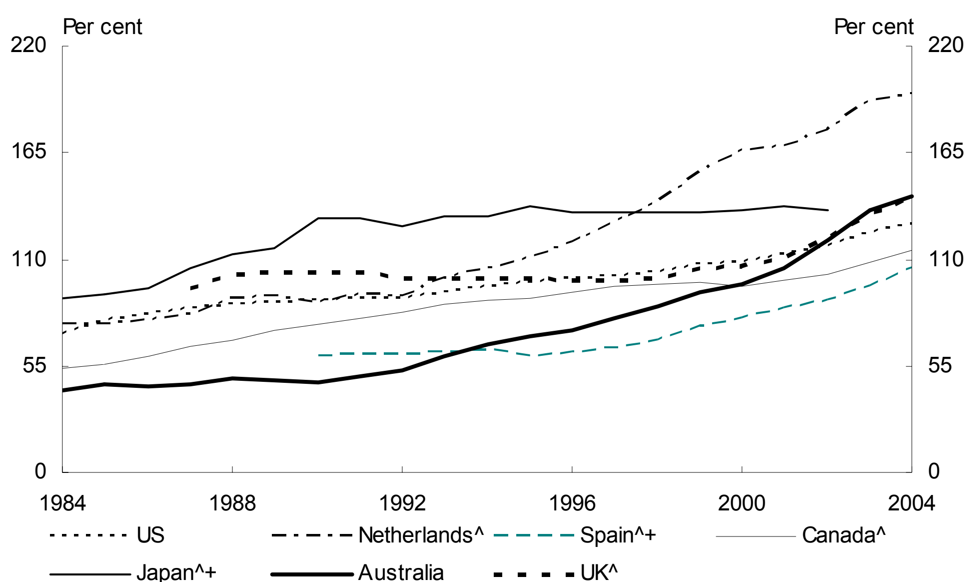
4.27 The debt to income ratio measures the size of debt as a percentage of disposable income. However, not all commentators agree that this statistic is useful.

11 The Treasury, *Submission 13*, p. 7.

The ANZ, for example, submitted that the gross debt to income ratios 'offer no reliable guide for assessing the vulnerability of the household sector and if used alone can provide a misleading view of fundamental conditions'. The ANZ submitted that to fully understand the issue of household debt, the level of debt must be examined in the context of a household's accumulated assets and current income.[12]

4.28 Historically, Australian households were debt adverse by international standards but in common with many other developed countries, they now carry much more debt, as shown in Figure 4.3.

**Figure 4.3: Household debt-to-income ratio, selected countries**




^ Includes unincorporated enterprises
+ Income is after tax and after the deduction of interest payments
All data is based on calendar years, except for Spain, which is based on financial years

Source: RBA.

### *Interest-to-income ratio*

4.29 A useful indicator of debt serviceability is the interest payments to income ratio. This measure shows what percentage of a household's disposable income is required to meet interest payments on their debt.

4.30 Treasury advised the Committee that despite a fall in interest rates, increased levels of debt means that interest payments now take up a higher proportion of income compared with the last decade. Figure 4.4 shows how average interest payments-to-income are now above the peaks of the 1980s and early 1990s.

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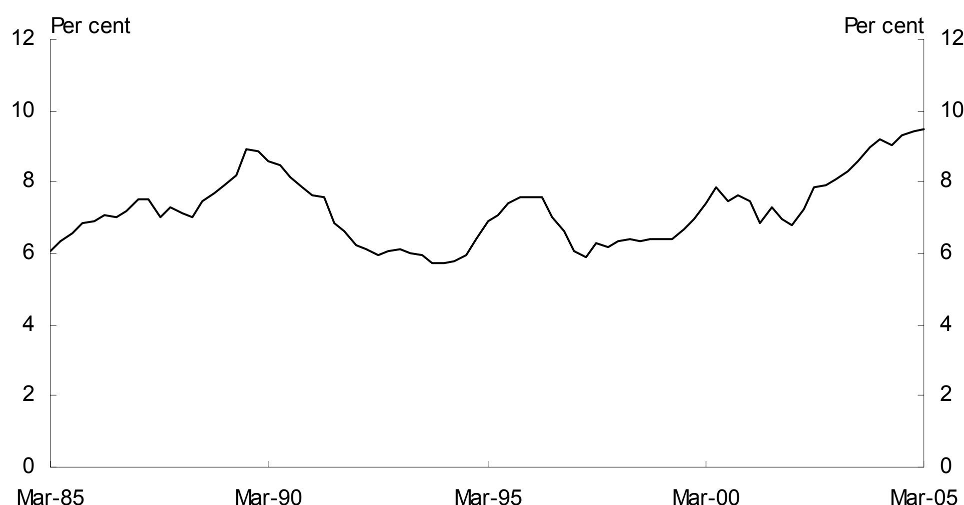
[12] ANZ, *Submission 17*, p. 3.

**Figure 4.4: Interest payments-to-income ratio of Australian households**




Source: Australian Bureau of Statistics cat. no. 5206.0.

### *Household-gearing ratio*

4.31 The household-gearing ratio shows the percentage of assets encumbered by debt, that is, the amount of debt the household has as a percentage of total assets. The ANZ advised the Committee that while the gearing ratio is rising, it remains well below international benchmarks.

4.32 Figure 4.5 shows the gearing ratio in Australia compared to a number of selected countries. Although the gearing ratio of Australian households is now higher than many OECD countries, including the USA and UK, because of the substantial increase in house prices in recent years Australia's household gearing ratio (household debt to assets) remains relatively low by international standards.[13]

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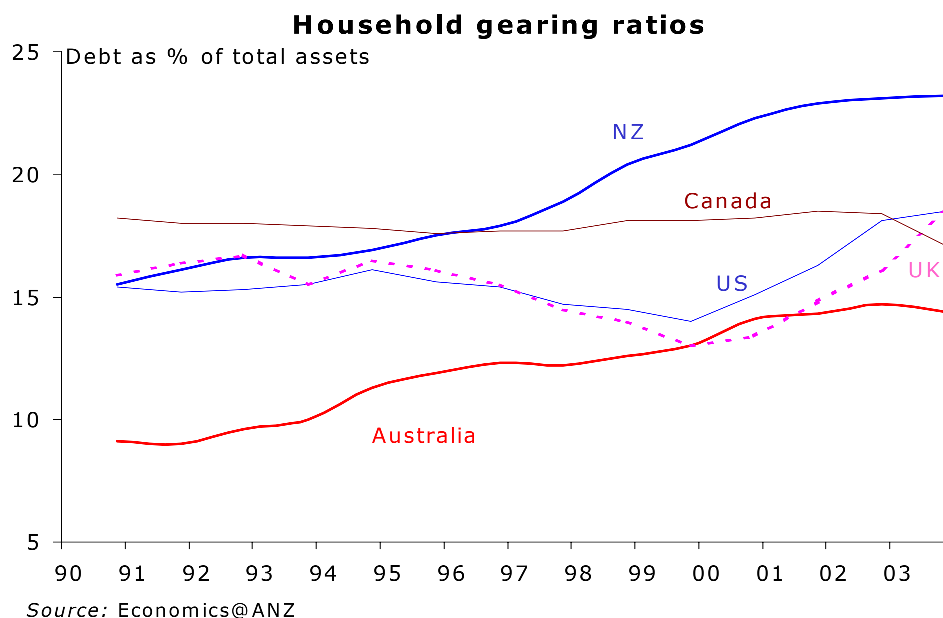
13 ANZ, *Submission 17*, p. 4.

**Figure 4.5 – Household gearing ratio (Debt as a % of total assets)**




4.33 The Australian Bankers' Association (ABA) told the Committee that while debt is high, it is 'still reasonably small compared to household assets'. The Association advised that debt is equivalent to twenty per cent of assets, and that this ratio has been stable for a number of years. The ABA acknowledged that this ratio is around twice what it was in the 1980s, meaning that households are now more highly geared.

4.34 Again, the RBA considers that this statistic understates the true figure for those households who hold housing debt. In July 2003, the RBA estimated that when the figure is adjusted to take account of those households who have no housing debt, the average gearing ratio for those that do have housing debt rises to about 43 per cent.[14] A subsequent study conducted by the RBA and released in July 2003 estimated the ratio to be 48 per cent.[15]

4.35 As pointed out by the Treasury in its submission, all of these measures have limitations. Perhaps the major limitation is that they present an average picture, where in reality large variations in debt and circumstances will be evident between individual Australian households.

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14 RBA, *Do Australian households borrow too much?*, speech by Mr I J Macfarlane, Governor, to the Sydney Institute, 3 April 2003, p. 5.

15 RBA Economic Group, *Housing Leverage in Australia*, Luci Ellis, Jeremy Lawson and Laura Roberts-Thomson, July 2003, p. 8.

## How are households coping?

4.36 The household sector's debt levels are now at historically high levels, and this is reflected in most measures of debt serviceability. In its most recent report, the RBA reported that:

> Both as a result of higher debt levels, and the increase in mortgage rates earlier this year, the ratio of aggregate household interest payments to disposable income has increased further to 9.8 per cent, the highest level on record. The total repayment burden, allowing for principal repayments, is higher again relative to past experience, given the increase in average loan size.[16]

4.37 However, the available evidence indicates that most of those households that are carrying heavy levels of debt are well-placed to meet their repayments. As both the Treasury and RBA have observed, there are few signs of financial distress, and default rates on all forms of credit are very low. The exception is a very small number of households (compared to the size of the population that has debt) who are undoubtedly in difficult situations, usually as a result of inadequate income levels.

4.38 Financial counselling organisations agree that most Australians seem to have little difficulty managing their household debt. For example, the Care Financial Counselling Service (CFCS) told the Committee that 'Most consumers do not appear to have any problems managing their increased levels of debt.' However, the CFCS went on to say that it had experienced a marked increase in demand for its services:

> …the disparity between those coping well and those on the brink or already in crisis is becoming more marked. For example, CARE noted a dramatic increase in demand for its services in the first 6 months of 2004. [The number of] clients over 50 seeking assistance has risen from 12% to 24% in 3-4 years.[17]

4.39 The CCLC questioned the validity of relying on default rates as an indicator of financial stress, arguing that there are three reasons why this may mask the true situation:

> The first is fairly obvious - that is, we have had fairly solid economic conditions for some time now so if default rates are going to be low then now is the time that they will be and any form of economic downturn might have an effect on that.
>
> The second one is that we see clients making very creative use of the availability of other credit in order to mask potential default situations. We have clients who refinance their credit over and again…roll their credit card debts over into their home loan…and, at the extreme, use one credit card to

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16 RBA, *Financial Stability Review*, p. 11.

17 CFCS, *Submission 2*, p. 3.

> pay another. … They really have no capacity to make the payment at all; they are using it as a mechanism to mask their situation.
>
> The final thing, which we think is perhaps the biggest problem when looking at the default rate, is that in the last 10 or 20 years we have moved to a completely new scenario whereby, instead of paying off loans, people are making minimum payments. This is not something which happened in the past…What we have now are credit cards and store cards - the most obvious example of continuing credit facilities - whereby people will sit for many years with their balance fully drawn. …When we look at defaults, we are not measuring people's ability to meet that debt; what we are measuring is their ability to meet the minimum payment only.[18]

4.40 The Australian Bankers Association (ABA) agreed that default rates do not necessarily provide the most reliable indicator of financial stress, but noted that determining financial stress levels was difficult:

> Finding the right indicator of households' financial stress is a very difficult exercise, and it is something that we have given thought to. We never make the claim that because defaults are at record lows there is no financial stress out there at all. It is a good indicator that overall things are looking pretty good for the economy and for households in general. But when you move away from defaults and look for some other measure, you then get into a debate about judgement and that is an awkward debate, something which we have not seen any definitive research on or answer to. It is something we are engaged in and we are looking at it and we are interested in seeing whether there is something useful we can do.[19]

4.41 People whose financial difficulties force them to seek the assistance of the many financial counselling groups in the community may be considered as experiencing financial stress, but it is difficult to obtain a reliable estimate of the number of people who avail themselves of these services. The following statistics provide some indication of the number of people who get to the point that they need external assistance.

- a survey conducted by members of the Financial Counsellors' Association of NSW (FCAN) indicated that 2 322 clients presented for counselling in NSW during 2003;[20]
- CARE Inc Financial Counselling Service (CARE) reported that it responded to over 2 200 new requests for assistance in the ACT during 2004;[21]

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18 *Official Committee Hansard*, 16 May 2005, p. E22-23.

19 *Official Committee Hansard*, 16 May 2005, p. E73.

20 FCAN, *Submission 1*, iii.

21 CFCS, *Submission 2*, p. 2.

- the Credit and Debit hotline operated by the Consumer Credit Legal Centre (NSW) Inc (CCLC) took 2 512 calls from the public and financial counsellors in the first 5 months of operation;[22]
- the CCLC received between 4 500 and 5 000 calls in the period Sept 2004 – May 2005[23];
- Anglicare Tasmania assisted 1 200 individuals and families during the 2003-04 financial year; [24]
- in 2002-03, financial counsellors under the Commonwealth Financial Counselling Program assisted approximately 16 000 clients; 25 and
- during 2003-04, one financial counsellor in Brisbane assisted 679 new clients and 399 existing clients. In Queensland, demand for financial counselling is increasing, and waiting periods to see a counsellor can be a few weeks.[26]

4.42 These statistics almost certainly under-report the number of people who are in financial distress or are approaching that state. As the Centre for Credit and Consumer Law, Griffith University (CCCL) noted in its submission:

> Other households, who are currently managing their credit commitments, may be at risk of default or financial hardship if their financial circumstances or other factors change. Unemployment, family breakdown, and ill health all feature as significant causes of financial difficulty.[27]

4.43 The CCLC told the Committee that many consumers in financial difficulties resort to bankruptcy and other insolvency arrangements, noting that in 2003-04, there were 16 441 non-business bankruptcies across Australia, and 5 482 Debt Agreements under Part IX of the Bankruptcy Act. Excessive use of credit was the second most common cause of non-business bankruptcies, after unemployment.[28]

4.44 A number of studies show that lower income households are the most likely to encounter difficulties. A report prepared for the FCAN found that 76 per cent of the associations' clients have incomes of less than $30 000 per annum. The primary causes of credit and other debt problems reported by clients in order of importance were unemployment (27 per cent), excessive use of credit (19 per cent), domestic discord (15 per cent) and ill health (14 per cent). Of those who reported excessive use of credit, credit cards are the principal source of difficulty.

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22 CCLC (NSW) Inc, *Submission 6*, p. 3.

23 *Official Committee Hansard*, 16 May 2005, p. E21.

24 Anglicare Tasmania Inc, *Submission 10*.

25 CCCL Griffith University, *Submission 11*, p. 3

26 CCCL Griffith University, *Submission 11*, p. 3.

27 CCCL Griffith University, *Submission 11*, p. 4.

28 CCCL Griffith University, *Submission 11*, p. 4.

4.45 While excessive use of credit is listed as a less significant reason for financial problems than might be expected, it appears to be the issue that causes the most problems when people encounter personal problems which reduce their earning capacity. The authors of the study observed:

> The typically low income of the majority of the clients…makes them vulnerable to uncontrollable factors such as loss of employment, domestic discord and ill-health.[29]

4.46 MasterCard confirmed that this is the case:

> One of the major reasons for debt defaults, as has been reported by a lot of research, is catastrophic life events such as ill health, divorce or the death of the primary breadwinner in a family. Almost always these life events are unforeseeable and, unfortunately, they are also usually totally unavoidable.[30]

4.47 On the basis of the evidence received by the Committee, it is difficult to sustain an argument that a significant proportion of the community are in financial distress as a result of excessive levels of household debt. It cannot be disputed however that there is evidence of a significant minority who are in distress, and a further group of indeterminate size who are not currently in financial distress but would have difficulty coping with a change in personal circumstances. As the CCLC observed:

> Probably not the majority of us but a very significant minority are using credit to mask an imbalance between income and expenditure. There are probably people who are using that credit proportion to buy luxury or imported goods and some who are using it to increase their capital wealth by investing in their own house, but we see a lot of people who are using credit just to live - people on fairly low incomes who are using credit facilities to purchase necessaries such as groceries, electricity, car registration and those sorts of things.[31]

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29 FCAN, *Submission 1*, attachment, p. 48.

30 *Official Committee Hansard*, 16 May 2005, p.55. (Mr Naffah)

31 *Official Committee Hansard*, 16 May 2005, p. E21-22.

## What are the future risks to households?

4.48 The RBA has been warning for some time about the risks associated with what it sees as unsustainably rapid increases in household debt. The major risk for many households is that they may have difficulty meeting repayments if the economic climate deteriorates or their personal circumstances change. As the Governor of the RBA warned:

> I suspect that a significant number of households have taken on a debt level which makes sense in the good times, but does not take into account the fact that bad times will inevitably occur at some time or the other.[32]

4.49 MasterCard was also among those who warned of the possible consequences of an economic downturn:

> …the existing issues with managing household debt will blow out significantly when the inevitable economic downturn eventuates.[33]

4.50 Despite the fact that there are few signs of financial distress among the household sector at present, the RBA has continued to warn that the household sector, through its excessive levels of borrowing and record levels of debt, is vulnerable:

> …the high levels of household debt make the household sector vulnerable to change in the generally favourable economic and financial climate. Given this, developments in household sector finances and the housing market will bear close watching in the period ahead.[34]

4.51 External factors appear to pose the greatest risk to the economic climate, for example, a general slow-down of the world economy. While remaining fairly optimistic about the prospects of the household sector, the RBA has previously laid out what it sees to be the major threat posed by continuing rapid rises in household debt:

> …the combination that would be most damaging to the Australian economy would be if the household sector were to continue putting itself into a more exposed position at the rate it has over the past few years, while at the same time a further weakening of the world economy was starting to feed through to activity and incomes. That would be a recipe for ensuring that, when the house price correction came, as it inevitably would if the world economy was weak enough, it would be bigger and more disruptive than otherwise. I am not saying that this is the most likely outcome, only that it is a risk we have to take into account.[35]

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32 RBA, *Do Australian households borrow too much?,* p. 7.

33 MasterCard, *Submission 15*, p. 3.

34 RBA, *Financial Stability Review*, September 2005, p. 16.

35 RBA, Opening Statement to the House of Representatives Standing Committee on Economics, Finance and Public Administration, 6 June 2003, p. 3. (from RBA website)

4.52 The RBA currently appears to be of the view that risks have abated somewhat due to an apparent slowing of the rate at which household debt is increasing. This slowing appears to be largely because the housing market has stabilised and some corrections are emerging as prices fall in some cities. There has been a marked change in the housing market over the last 18 months, and 'cooling is evident in conditions in all capital cities, although it is most pronounced in Sydney'.

4.53 The RBA has also commented that households appeared to be going through a period of consolidation.

4.54 While the overall picture is not alarming at present, some risks to households remain and in its recently released *Financial Stability Review* the RBA has warned that 'there remains a possibility that the adjustment could turn out to be much larger than currently anticipated'.[36]

4.55 However, the RBA notes that the correction to the housing market has, to date, proceeded smoothly, and this has helped alleviate concerns about a potentially more damaging adjustment at some point in the future.[37]

### *Interest rate rises*

4.56 The Treasury has warned that the household sector is now more sensitive to shocks such as higher interest rates or lower income and identified highly geared investors as being particularly at risk:

> The increased debt of the household sector is likely to make their consumption more sensitive to changes in (actual and expected) interest rates. The extent of the increase in sensitivity will depend on the distribution of the debt. For example, investors, some of whom are more highly geared, account for an increasing proportion of the housing market, and may react differently to owner-occupiers.[38]

4.57 However, the RBA is of the view that this is a somewhat over-stated risk, pointing out that interest rate rises are less likely in the more stable economic environment which now prevails:

> For a given rise in interest rates, it [households] will be more affected because the rise will apply to a larger loan. But it is probably not right to make the assumption about 'a given rise in interest rates'. That is because in the low inflation/low interest rate environment we have today, interest rates do not move about as much as before. In the late 1980s, on one occasion the

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36 *Financial Stability Review*, September 2005, p. 2.

37 *Financial Stability Review*, September 2005, p. 8.

38 The Treasury, *Submission 13*, p. 10.

> mortgage rate rose by 3½ percentage points in a year, in the 1990s we have had nothing like that (the largest rise in a year was 1¾ percentage points).[39]

*Recent borrowers and low income earners*

4.58 People who have recently taken out a mortgage tend to be more at risk in times of economic downturns or if their personal circumstances change, as their exposure to debt is at its maximum. However, this has always been the case, as the Governor of the RBA has pointed out:

> Of that 30 per cent of households, a lot have had the mortgage for a reasonable period and, during that period, their incomes have gone up or they have paid off part of their mortgage. The vulnerable group is the people who have just taken out a mortgage, and it was ever thus. The one time in your life when you are vulnerable, when you have a high amount of debt relative to your income, is when you first take out a mortgage.[40]

4.59 The RBA also acknowledged the nature of this risk for recent borrowers and also for lower income earners in its recent *Financial Stability Review*:

> Among borrowers with housing debt, those with the highest debt-servicing burdens, or the smallest buffers on which to fall back in adverse circumstances, are often those that have taken out loans only recently as well as lower-income households and investors.[41]

4.60 The Consumer Credit Legal Centre (Griffith University) advised the Committee that it thought that there were many households who were only just managing:

> High household debt levels pose significant risks for many households and individuals… many households are likely to be 'only just' managing their consumer credit obligations, and are vulnerable to changes in individual financial circumstances and/or economic conditions. [42]

### *Home equity loans and redraw facilities*

4.61 These products have been identified by the RBA on a number of occasions as a source of possible risk to households that use them. The RBA has observed that an increasing number of households have taken advantage of these facilities to top up their mortgages. While this does allow households to tap into their wealth, it does

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39 RBA, *Do Australian households borrow too much?*, p. 3.

40 House of Representatives Standing Committee on Economics, Finance and Public Administration, *Official Hansard*, 12 August 2005, p. 34.

41 *Financial Stability Review*, September 2005, p. 11.

42 CCLC Griffith University, *Submission 11*, p. 3.

have the effect that their debt levels stay higher for longer, leaving them exposed to changes in circumstances for longer periods.[43]

### *Investor housing*

4.62 The RBA has issued a number of warnings about the rapid rise of investor housing. This sector's activity has risen dramatically in the last decade, and investors are often highly geared. The RBA has been particularly concerned that many new investors do not fully understand the nature of the risks they face, which are considerably greater than for owner-occupied housing. As the Governor told the House of Representatives Standing Committee on Economics, Finance and Public Administration in June 2004, investors are vulnerable to a drop in property prices:

> I think there are a lot of people out there who thought they were going to get rich but they have this asset which is costing a lot of money to service and is not going up in price; rather it is going down, and it is hard to find tenants.[44]

### *Marginal borrowers*

4.63 The other group of households who are identified as being at risk if circumstances change are those who are described as 'marginal borrowers', who borrow outside of the normal lending limits imposed by the banks from non conforming lenders. The RBA notes that 'if economic conditions were to change, however, marginal borrowers are likely to be more vulnerable and one might expect them to quickly become distressed sellers in adverse circumstances'.[45]

## Committee views

4.64 The rise of household debt in Australia has been spectacular, but should be kept in perspective. A similar phenomenon has been observed in many other OECD countries, and in some, the rises have been even larger than in Australia. The rises have almost certainly had similar causes, low interest rates in most countries being a common feature. Persistent low interest rates in the USA have also had effects worldwide.

4.65 Household debt of itself is neither a good nor a bad thing. For many people, debt has provided a way to build wealth. It also allows people to smooth out their expenditure over their lifetimes. Debt only becomes a problem if it leads to unacceptable risks for those households who have substantial debt or to significant misallocation of resources within the economy.

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[43] See for example RBA, *Do Australian households borrow too much?*, pp. 3-4.

[44] House of Representatives Standing Committee on Economics, Finance and Public Administration, *Official Hansard*, 4 June 2004, p. 15.

[45] RBA, *Financial System Stability – some current observations*, speech by John F. Laker, Assistant Governor (Financial System), 16 May 2003, p. 13.

4.66 The rises in debt that have occurred have been unsustainable, as the RBA has been warning for some time. They have also had some unfortunate outcomes, not the least of which is that housing has become very expensive and is now unaffordable for all but those who appear to hold most of the debt, that is, well established, mid-life high-income households. Low income households and younger people are severely disadvantaged in such an overpriced market.

4.67 Fortunately, the rate of increase has moderated, although there are no guarantees that it will not resume where it left off.

4.68 Could the rises have been prevented? The answer is almost certainly no, although some fiscal policy settings such as the changes to the capital gains tax (CGT) in 1999 may have contributed to the rises that took place. The coincident factors of readily available finance resulting from deregulation and major reductions in interest rates meant that demand in the housing market would inevitably intensify, with increases in house prices an inevitable result. When the other pro-cyclical factors of rising incomes, rising employment, increased numbers of people seeking housing for investment purposes and wealth effects are added to the equation, a 'perfect storm' was an inevitable result, as could be seen in the very rapid increases in house prices that occurred.

4.69 Should government policy be changed to slow future rises? The Committee considers that there is a case for removing some of the pro-cyclical factors from the housing market, although caution is required to ensure that over-reaction does not result. The Committee notes that the Productivity Commission has recommended that the Australian Government establish a review of those aspects of the personal tax regime that have recently contributed to excessive investment in rental housing, with a focus on the capital gains provisions.[46] The Committee also notes that the Government has rejected this recommendation. Nonetheless, the Committee considers the recommendation to have merit, as reviewing the CGT provisions offers one of the few realistic alternatives available for moderating the excessive demand for investment housing, a significant distortion in the housing market.

4.70 The Committee does not consider that it is practical or desirable to wind back the clock on financial sector deregulation, which despite having had a number of possibly unforeseen unexpected effects, has overall been beneficial for both the household sector and the economy. It has led to many efficiencies and made finance more readily, on a more equitable basis. Re-imposing limits on lending would not gain any community support.

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46 Productivity Commission Inquiry Report, *First Home Ownership*, No. 28, 31 March 2004, pXXV.

4.71 However, there is a case for ensuring lending is conducted responsibly, as discussed in the previous section, where the Committee welcomed a number of initiatives to address unsound lending practices. The Committee believes that it is essential that the non-conforming lending sector be subject to more stringent scrutiny of how it conducts its business, particularly as it is in direct competition with the deposit-taking sector which is subject to stringent prudential requirements and supervision by APRA. The Committee considers that there is a strong case for ensuring that conforming and non-conforming sectors face the same regulator framework, particularly in relation to consumer protection requirements.

4.72 The Committee noted with interest a comment in the AMWU submission that the European Central Bank sets a target for the growth of credit in the economy equal to the product of the desired growth in GDP and inflation, giving a rate of growth of between 4 and 5 per cent per annum, and that this target is an objective of monetary policy. The sole objective of monetary policy in Australia is to keep inflation within the target range.[47] The Committee has not taken any evidence on the EU approach and is well aware that it would, if adopted in Australia, represent a major change to what overall has been a successful policy approach. While the Committee is not advocating that such an approach is necessarily appropriate for Australia, it suggests that the RBA should consider whether setting a target is desirable, and how it might be achieved.

**Recommendation 4**

**The Committee recommends that the Government reassess its decision to reject the recommendation of the Productivity Commission for a review of those aspects of the personal tax regime that have recently contributed to excessive investment in rental housing.**

4.73 The Committee is encouraged by the RBA's assessment that risks to households from rising household debt levels do not appear to be high at present. However, there are few grounds for complacency, and the risks, while not yet pressing, require close monitoring and in some cases, action.

4.74 The Committee is of the view that much more should be done to educate borrowers of the risks associated with investing in real estate; of borrowing against equity; and of borrowing at debt-to equity ratios in excess of 80 per cent.

4.75 Furthermore, the Committee notes and supports the findings and recommendations in the report of the Parliamentary Joint Committee on Corporations and Financial Services titled 'Property investment advice – safe as houses?', dated June 2005.

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47 AMWU, *Submission 4*, p. 4.

**Recommendation 5**

**The Committee recommends that through the Ministerial Council on Consumer Affairs, the State and Territory Governments develop and pass uniform legislation for the development of educational material focussed on the risks associated with investing in real estate, borrowing against home equity, and of borrowing at debt-to-equity ratios in excess of 80 per cent; and that real estate agents be required to provide copies of this material to prospective buyers at the point of first enquiry.**

# Chapter 5

## Lending practices and household debt

> *Everyone enjoyed it so much when lending was growing at a rapid rate - businesses were all making lots of profits; shareholders were happy; management thought they were geniuses - and they want the party to continue. The only way it can continue is by lowering credit standards or, the other term for that, underpricing risk.*[1]

### Introduction

5.1 The question of whether the lending policies and practices of banks and other lenders have played a significant role in increasing household debt is contentious. Representing the banking sector, the ABA maintains that demand for credit is the primary driver of increased household debt. Nonetheless, the lenders market their products aggressively, each institution seeking to maintain market share and maximise profits. Appearing before the House of Representatives Standing Committee on Economics, Finance and Public Administration, the Governor of the RBA, Mr Macfarlane was under no illusions about the lenders' motives:

> There is a very big industry out there which is utterly determined to put out as much credit as it can.[2]

5.2 A number of regulators and commentators have expressed concern that in their pursuit of market share, some lending institutions have lowered lending standards and in some cases, engaged in questionable practices. Critics say that a number of these practices lead to excessive levels of debt in households who, because of their financial and personal circumstances, are at risk of becoming over-extended and of financial distress.

5.3 In the credit card market, the practice of offering unsolicited increases in credit limits has been criticised by a range of consumer groups. Critics point out that the practice can lead to over-commitment and financial hardship if adequate checks are not made of whether the person who is offered the limit increase is able to pay it.

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[1] Governor of the RBA, Mr I Macfarlane, in House of Representatives Standing Committee on Economics, Finance and Public Administration, *Official Hansard*, 12 August 2005, p. 8.

[2] House of Representatives Standing Committee on Economics, Finance and Public Administration, *Official Hansard*, 4 June 2004, p. 16. Quoted from the Committee's report, *Review of the Reserve Bank of Australia Annual Report 2003*, p. 18.

5.4 Operators of department store charge cards are singled out for the practice of offering inducements such as no-deposit buying and interest free periods and when these expire, charging very high rates of interest. In the case of both credit and charge cards, disclosure of terms and conditions are claimed to be often inadequate.

5.5 Examples of poor practice in the housing market include commission-driven promotion of mortgages by brokers, with insufficient attention being paid to accepted lending standards; and attempts on the part of some lenders to distance themselves from their responsibilities under the Consumer Credit Code.

5.6 This chapter commences with a discussion of lending standards and practices, which is of relevance to household debt in general, but particularly the housing loan market. Subsequently, the chapter examines issues of more relevance to the credit and charge card sectors, which were the main focus of attention by organisations that made submissions to the inquiry.

5.7 The chapter concludes with an examination of a number of options that have been put forward for reducing the likelihood of households becoming overextended particularly in relation to credit card and charge card debt. These include:

- Mandatory checking of capacity to pay;
- Financial literacy measures; and
- Positive credit reporting.

## Lending standards and practices

5.8 Both the Australian Prudential Regulation Authority (APRA) and the Reserve Bank of Australia have expressed concern that as a result of fierce competition for market share, some lenders have compromised lending standards.

5.9 APRA advised the Committee that it has kept the activities of Australian Deposit Taking Institutions (ADIs) under close scrutiny. While providing assurances about the financial soundness and stability of the financial sector, APRA described a number of shortcomings in lending practices which it had identified:

> In its supervisory activities, APRA has identified slippages in basic lending practices, in areas such as verification of customer data and valuation processes. APRA also sees increasing reliance on the information collected by third parties (such as mortgage brokers and mortgage managers) without independent verification by the ADI.
>
> …

> APRA has also observed that ADIs are no longer relying on conservative rules of thumb when assessing a borrower's capacity to repay debt. The traditional '30 per cent rule', under which lenders would limit repayments to no more than 30 per cent of a borrower's gross income, has been giving way to a debt servicing ratio approach, which treats all income above a cost of living estimate as potentially available for servicing debt.[3]

5.10 APRA has revised a number of its policies and issued warnings to ADIs about these practices.

5.11 The RBA is also closely monitoring lending practices, and appears to be concerned that unsound practices are increasing in response to increased competition and lower growth in demand and more difficult market conditions resulting from the slowdown in the housing market:

> So there is a huge amount of competition to retain market share going on out there, and this is common in credit cycles towards the end of a credit cycle. Everyone enjoyed it so much when lending was growing at a rapid rate - businesses were all making lots of profits; shareholders were happy; management thought they were geniuses - and they want the party to continue. The only way it can continue is by lowering credit standards or, the other term for that, underpricing risk. We think a fair bit of that is happening at the moment and we have been following it.[4]

5.12 The Governor of the RBA, Mr Macfarlane, has criticised the fall in lending standards. He attributed this fall at least in part to a change in the incentives associated with distributing mortgages resulting from the increasing importance of the broking industry:

> When I said earlier that lenders may be tempted to further lower lending standards, the use of the word *further* was deliberate. The incentives in the mortgage distribution system have changed in such a way that there has been a step-by-step reduction in credit standards over recent years. A significant proportion of mortgages are now sold by brokers who are paid by commissions on volumes sold.

5.13 Mr Macfarlane also identified the entry of new lending products as contributing to the general decline in standards and an increase in the amount of debt that a lender was prepared to lend against a particular income level:

> The growth of low-doc home loans means that intermediaries are now lending to individuals whose income is not substantiated. There has also been an upward drift in the maximum permissible debt-servicing ratio. When once a maximum of 30 per cent of gross income was the norm, now

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3 APRA, *Submission 3*, p. 3.

4 Governor of the RBA, Mr I Macfarlane, in House of Representatives Standing Committee on Economics, Finance and Public Administration, *Official Hansard*, 12 August 2005, p. 8.

> it is possible for borrowers on above-average income to go as high as 50 per cent of gross income (and a much higher percentage of net income). The new lending models used by the banks (and provided on their websites to potential borrowers) seem to regard the bulk of income above subsistence as being available for debt-servicing.

5.14 He went on to warn that once these practices gain a foot-hold in the market, they can spread to more conservative, prudent lenders:

> It is not hard to see how a situation like this develops. Once a few lenders adopt an aggressive approach, others must match them or lose market share. They are then re-assured by standard risk-management models, which are based on Australia's history of extraordinarily low mortgage defaults. Even those lenders who have reservations find it difficult to follow a different path, especially as the lenders taking on more risk may well be rewarded by higher profits (and higher share prices) in the short run.[5]

5.15 A number of organisations that made submissions to the inquiry also raised concerns about an apparent disregard for sound lending practices on the part of some lenders.

5.16 The Centre for Consumer Law (CCL) at Griffith University was among several non-financial sector submissions that criticised the lending policies of banks and other credit providers. The CCL told the Committee of a number of practices that it said credit providers had increasingly been using to provide loans to people who may not have been successful in obtaining finance in the past, including:

- Consumers with little or no savings can seek out loans with higher loan to valuation ratios (95-100 per cent). The creditor's interests are protected with mortgage insurance and/or other restrictions, but the borrower is left with a limited buffer if their financial circumstances change and/or the property value decreases;
- Low-doc and no-doc loans enable loans to be provided on the basis of a self-certification of the borrower's capacity to pay the loan, with the creditor making little or no independent enquiries;
- Other forms of non-conforming loans have become available or promoted to consumers, including vendor finance and interest only loans;
- Some lenders appear to engage in asset-based lending for consumer purposes, where little assessment is made of the borrower's capacity to pay the loan; instead, the credit provider relies on its ability to force a sale of the security property at the end of the loan term;

5 RBA, *Monetary Policy and Financial Stability*, speech by the Governor, Mr I. J. Macfarlane, 16 November 2004.

- Home equity and reverse equity loans have become increasingly available. These loans can be used to fund renovations or non-housing expenses, and they add to the size of the mortgage over time;
- Greater promotion of refinancing of home loans and debt consolidation. Often this involves an additional borrowing on top of the refinanced or consolidated loans; and
- Lower standards of credit assessment.[6]

5.17 Similar evidence was received from representatives of the Consumer Credit Legal Centre (NSW) Inc (CCLC), who alleged that in some cases, loan applications had been falsified or borrowers' capacity to pay deliberately misrepresented:

> The other area where we have seen a deterioration is home lending. There has been a change in attitude towards things like income ratios - what percentage of income is appropriate to service a loan. There are higher loan to value ratios, greater use of things like deposit bonds and widespread use of third party channels such as brokers. Our experience of brokers is that, whereas many of them are probably extremely responsible and professional in the way they provide their service, we see the results of a lot who are not. More and more people are coming in who have a loan secured against housing, who have very little income and whose loan applications have been seriously doctored-basically their loan application contains information that is simply incorrect.[7]

5.18 There appear to be some important incentives for mortgage brokers to pay insufficient regard to borrowers' capacity to repay loans. An APRA survey released in 2003[8] found that in a majority of cases, brokers' remuneration packages are based on the volume of business generated, providing brokers with an incentive to generate volume without appropriate regard to risk.

5.19 It appears that some fringe non-conforming lenders and a group of unscrupulous mortgage brokers or intermediaries purporting to provide loan reduction services may be responsible for such shady practices. On the basis of the evidence received, it is not possible to exclude the possibility that some banks who are lending through mortgage brokers may also be involved, either inadvertently or in complicity. The Committee notes that the four major banks received 60 per cent of all broker loan applications in the March 2002 quarter, indicating that they are heavily dependant on the broking industry.[9]

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6 Centre for Consumer Law, Griffith University, *Submission 3*, p. 4-5.

7 *Official Committee Hansard*, 16 May 2005, p.E22.

8 APRA, *Report on Broker Originated Lending*, January 2003, p. 9.

9 Discussion paper, *National Finance Broking Regulation - Regulatory impact statement*, published on line by the Office of Fair Trading, Government of NSW, p. 8.

5.20 It is difficult to determine the extent of such practices. However, Ms Cox of the CCLC implied that some mainstream lenders are involved, as part of the pressure to increase market share, and that in some cases, lenders are seeking to avoid the application of the consumer credit code, which applies in all states, and requires lenders to assess capacity to pay:

> Our concern was that the fact of that meant that lenders who were previously more careful, who would take note of things such as the consumer credit code - that says in section 70, among other things, that you are not supposed to knowingly lend to people in a situation in a situation where you know they would incur hardship to repay - are happy to be able to distance themselves in that regard. That is what we have found. They are able to increase the market share by… They put a Chinese wall between themselves and the borrower and say, 'We have done everything we possibly could.' Without naming particular institutions, there are some whose mortgage portfolios are growing enormously through using the broker channel.[10]

5.21 The CCLC attributed this problem to the increasing presence in the finance industry of mortgage brokers, and as a result, the remedies that should have been available to the consumer to seek redress in cases where lending was irresponsible were no longer available to consumers:

> Probably the biggest impact that we have seen is simply that credit providers are moving to distance themselves from transactions, so whereas once you dealt directly with the credit provider, you are now dealing with a broker and in some cases a second broker or a mortgage manager in the middle. Quite contrary to situations where those people are seen as the agent of the credit provider, in Australia the law has developed so that most of them are actually seen as the agent of the consumer. As a result, many of the traditional remedies available to consumers when things go wrong are no longer available because when they take it to the credit provider, the credit provider says, 'No, nothing to do with us.'[11]

5.22 The CCLC told the committee that this was a common problem in their casework. Representatives agreed that it was a problem most commonly seen among individuals that were financially distressed, but was not confined to that group.

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10 *Official Committee Hansard*, 16 May 2005, p.E30.

11 *Official Committee Hansard*, 16 May 2005, p.E26.

5.23 The Committee explored options for addressing this problem with representatives of the CCLC, who suggested that one option would be to make the lender responsible for ensuring the borrower had adequate capacity to repay the debt:

> **Senator BRANDIS**: Do you go so far as to suggest to this committee that, if the law were changed so as to deem a broker to be the agent of the lender, that would solve the problem?
>
> **Ms Lane**: In a nutshell, we think that would be a very significant step forward in solving this problem.[12]

5.24 A failure on the part of brokers to disclose fees adequately or explain how their fees would apply to a particular transaction was also identified by some consumer groups as a feature of some operators in the mortgage and finance broking industry. This is despite a legal requirement to disclose fees. It was alleged that in some cases, failure to adequately inform consumers of the fees applying to particular services led to some households being misled into re-financing deals that did not benefit the borrower and resulted in financial hardship. Some of the fees charged appear to be disproportionately large. Ms Lane of the CCLC (NSW) told the Committee of some of the situations she had encountered in her casework:

> If the fees were disclosed at all, it was often as a percentage - which sounds fairly small until you realise how much one per cent, two per cent, three per cent or four per cent can be over a fairly large loan. The biggest problem with disclosure is for the really vulnerable client group. It would not matter what was in a disclosure document, the situation of some of our clients is such that they would be very easily duped into signing things. People who are about to lose their home are particularly vulnerable in that respect. We have seen more and more cases in the last few years. With the rise of the non-bank sector, there are people who perhaps would have defaulted on their home loan earlier but, rather than default now, they take up an option, usually offered through a broker, whereby they refinance to the nonconforming sector. They may last a few months or they may last a few years, but they inevitably default anyway.
>
> …
>
> We have seen clients paying $10,000 to $15,000 simply in set-up fees to get a relatively small loan. The current record was $20,000.[13]

5.25 The ABA and the ANZ Bank both submitted that the banks are conservative in their approach to lending, and that commercial imperatives mean that they aim to lend responsibly. The ABA's submission provided details of the

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12 *Official Committee Hansard*, 16 May 2005, p.E30.

13 *Official Committee Hansard*, 16 May 2005, p.E27.

safeguards that exist in the banking sector to ensure lending is conducted responsibly, highlighting:

- Income and equity tests are applied;
- Commercial incentives to ensure loans were repaid;
- Application of the Uniform Consumer Credit Code;
- Code of Banking Practice;
- Existence of external dispute resolution in the Banking and Financial Services Ombudsman; and
- APRA's supervision of prudential standards.[14]

5.26 Similarly, the ANZ provided the Committee with a description of its practices that are intended to ensure it is a responsible credit provider.[15]

### *Committee views*

5.27 It is impossible to escape the conclusion that the lending policies and practices of lenders have had a significant impact on the demand for debt. There has been cut-throat competition for market share and enormous pressure to increase profits. The practice of raising debt-to- income repayment ratios alone allows more money to flow into an already overheated housing market, potentially increasing the risks for households who may not fully appreciate the nature of the risks that they are undertaking.

5.28 The finance droughts of the pre-deregulation years have given way to the reverse, a flood of finance into the market that lenders are anxious to place. The commercial incentives for doing this are understandable but can also have negative aspects. There is evidence that at least some lenders have sought to increase their share of the housing mortgage market and the size of their mortgage portfolios through lending practices that are unsound and in some cases, unscrupulous. This appears to be a particular problem among non-conforming lenders and mortgage brokers.

5.29 While the Committee accepts that much lending by the banks is responsible, it is concerned about the increasing reliance of banks on the mortgage and finance broking industry. The broking industry is as yet only lightly regulated and the barriers to entering it are low. There is an attendant risk that the safeguards and procedures put in place by the banks to ensure lending practices are sound will be watered down or ignored. In the never-ending quest to lower costs and at the

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14 APRA, *Submission 3* – see pp 3-6.

15 See ANZ, *Submission 17*, pp. 11-12.

same time, increase profitability and market share, the potential for standards to be compromised is ever-present.

5.30 The Committee notes APRA and RBA concerns about lending standards being reduced. The Committee also notes that the House of Representatives Committee on Economics, Finance and Public Administration has identified the lack of regulation of non-bank lenders as problematic as it tends to fall between the states' responsibilities and those of APRA and ASIC. The Committee shares these concerns.

5.31 The Committee is aware of a number of initiatives to address the problem of unsound lending practices. These include:

- The Ministerial Council on Consumer Affairs has released a comprehensive discussion paper exploring options for uniform state and territory regulation of the finance and mortgage broking industry, and acknowledging the importance of the issue, has agreed to progress as a matter of urgency proposals to address the problems raised;
- At the initiative of the Australian Government, the States and Territories have established a working party to investigate property investment advice;[16]
- The Joint Parliamentary Committee on Corporations and Financial Services released a report entitled *Regulation of Property Investment Advice* in June 2005.

5.32 APRA has also taken a number of initiatives including:

- proposed the introduction of more detailed criteria for Australian deposit-taking institutions (ADIs) to qualify for the concessional risk-weighting of residential mortgage lending;
- strengthened the capital adequacy standard for ADIs by requiring them to treat certain types of capitalised expenses such as loan origination fees and commissions paid to mortgage originators and brokers as intangible assets for prudential purposes, and to deduct them from capital;
- proposed an improved capital framework for lending mortgage insurers;
- conducted a 'stress test' of ADIs and warned them to be more cautious in housing lending.[17]

5.33 The Committee welcomes these initiatives.

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16 Described in the Government Response to the House of Representatives Standing Committee on Economics, Finance and Public Administration Committee's report: *Review of the Reserve Bank of Australia Annual Report 2003.*

17 Described in APRA, *Submission 3*.

**Recommendation 6**

**The Committee recommends that the feasibility of deeming a broker to be the agent of the lender be further investigated as a possible method of addressing the slippage in lending practices that has entered the financial services industry.**

## Credit and charge cards

5.34 Credit and charge card lending is minor in comparison to lending for housing, although it is an area which attracted considerable comment by many of those who made submissions to this inquiry. Credit and charge card debt has shown a similar rate of growth over the last ten years as housing debt and totalled $31.4 billion as at June 2005, 5.4 per cent of total household debt.[18]

5.35 During the inquiry, submissions and witnesses mainly focused on problems faced by those households who are financially distressed as a result of using cards. While the number of distressed households appears to be small, severe financial hardship can result for those who do have difficulties managing credit and charge card debt.

5.36 Low household income is the major risk factor associated with financial hardship attributed to credit and charge cards, although problems also arise for higher income groups.

5.37 The rest of this chapter focuses on lending practices that contribute to credit debt difficulties, particularly unsolicited offers of credit increases and the failure to undertake realistic assessments of capacity to pay. The chapter concludes by canvassing a number of options for reform in this area.

### *Unsolicited credit increases*

5.38 The CCLC and a number of other organisations told the Committee that the practice of sending out unsolicited offers of increased credit limits to people without checking whether they were capable of repaying that higher level of debt caused many problems for the at-risk group. Representatives also alleged that in many cases the financial institutions offering the credit increase were aware of their customers' limited repayment capacity:

> A lot of our clients have been offered increase after increase in their credit limit with no reference to their income and liabilities. Some of these people have had a change in income whereby they have a lower income than they

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18 Derived from RBA, *Credit and Charge Card Statistics*, Table C1, http://www.rba.gov.au/Statistics/AlphaListing/alpha_listing_c.html

> had when they were first granted the credit facility, but many of them have never had a change in income and the credit provider has been well aware of their financial situation from the start.[19]

5.39 Several organisations submitted that few checks are made of whether people are capable of repaying the debt that may be incurred as a result of a credit limit being increased, or before issuing a card. Submissions were also highly critical of the practice of assessing ability to repay on whether the person could make minimum payments, rather than whether the debt could be repaid within a realistic period. The CCLC elaborated:

> Another key factor contributing to problematic credit card debt is that many lenders assess a client's capacity to pay on whether they can afford the minimum monthly payment. This means that even where some form of credit assessment is carried out by it, borrowers may face financial difficulty if they fully draw their account. The result of this is that there is a gap between financial difficulty as measured by default rates and real levels of debt related stress in the community.[20]

5.40 FCAN considered that many people do not really understand the nature of the debt they are entering into:

> Many people do not understand that most forms of credit such as credit cards from financial institutions have daily compounding interest. Many also feel that paying minimum payment required by a credit card statement will repay the debt only to find out down the track that this is not the case. Making the minimum payment will keep the debt out of the court debt recovery process, as it is the required payment, but may only cover interest and a small amount of the principal. It may take years to fully repay a credit card debt if only the minimum required payment is made.[21]

5.41 A submission from the Banking and Financial Services Ombudsman (BFSO) confirmed that the practice of increasing credit card debt without undertaking an assessment of a customer's capacity to increase the increase in credit has contributed to an increase in credit disputes. The Ombudsman, in common with a number of other submissions, noted that the increased limit in some cases results in a debt that the customer cannot afford to repay.[22]

5.42 Charge cards, particularly those operated by finance companies such as GE Finance, were also identified as a source of problems for some households. The Committee received a limited amount of evidence about these cards, and many of the issues raised were similar to those in relation to credit cards. Issues include a

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19 *Official Committee Hansard*, 16 May 2005, p. E22.

20 CCLC, *Submission 6*, p. 9.

21 FCAN, *Submission 1*, p. 1.

22 BFSO, *Submission 12*, p. 6.

lack of disclosure of the true cost of operating a card; unsolicited cards being offered to consumers without adequate checking of the customer's ability to service debt, and a lack of information about interest-free periods and the rate at which interest will be charged after the interest-free period expires.

5.43 Anglicare Tasmania was amongst those who criticised the practices of finance providers and stores in relation to these cards:

> The ease by which consumers can access credit to purchase these goods, in particular interest-free period loans and in-store credit that is offered by most large department stores and chains at very high interest rates (up to 25 per cent) further encourages/supports consumers to purchase luxury items that they often cannot realistically afford. At present, little financial information needs to be provided by the customer to access this form of credit and oftentimes clients do not fully understand the terms of the contract.[23]

5.44 Representatives of the ABA defended the practices of the credit industry, advising that in many cases the financial institutions had to rely on what the customer told them and were constrained by privacy rules from checking whether the information provided was correct:

> For example, if a customer is filling out an application for a credit card for the first time, they are asked to declare how many credit cards they have and what other credit facilities they have in place. We have no real means of checking whether or not that is the case, because of privacy rules…a customer could have a number of credit cards which they do not necessarily disclose to us, which we do not know about and which, if we did know about them, would affect our decision to lend.[24]

5.45 The ABA maintained that it was not in the industry's interest to have people take out credit that they could not repay. The ABA acknowledged that circumstances do arise where people take on more debt than they can manage, but maintained that 'We try everything possible to militate against that'. Representatives said that the industry had financial literacy programs in place to try and mitigate the problem, and also actively managed peoples' accounts. The ABA pointed out that the industry is in a situation where it is difficult to satisfy all people, and that by tightening up lending there was a risk that people who should have access to credit would be denied it:

> The response from banks is that they could tighten up their risk parameters so much to prevent that sort of thing from happening. But if you do that you end up denying money to people who should get it.[25]

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23 Anglicare Tasmania, *Submission 10*, p. 2.

24 *Official Committee Hansard*, 16 May 2005, p. E69.

25 *Official Committee Hansard*, 16 May 2005, p. E72-3.

5.46 A number of submissions and witnesses put forward a number of recommendations for addressing the issue of uncontrolled credit card debt. These include:

- Improving disclosure standards;
- Financial literacy programs;
- Mandating assessment of ability to repay debt; and
- Positive credit reporting

### *Disclosure standards*

5.47 As is evident in the preceding paragraphs, a number of organisations consider that one reason some people have difficulty managing credit is that they do not adequately understand the nature of the commitment they are entering when they incur debt on credit or charge cards. Some identify credit card contracts where the terms and conditions are set out as excessively complex or buried in small print. The conditions are disclosed, but many people have difficulty understanding them.

5.48 Virgin Money was highly critical of the disclosure standards imposed on Australian financial institutions:

> The impact of rising credit card fees and interest charges on consumers is compounded by a lack of honesty and transparency in credit card marketing. Many Australians do not adequately understand the terms and conditions of their credit, making it all too easy for the more vulnerable to be trapped into accumulating unaffordable debt. It is this area where we believe regulation can make a difference - in increased disclosure to consumers of basic credit card product features.[26]

5.49 Virgin Money was of the view that Australian financial institutions would resist disclosure improvements, but that requiring higher standards would benefit consumers:

> But forcing disclosure of interest rates and fees would drive natural competition to bring those down and improve the situation for consumers. The industry definitely has not followed and is not planning to follow, because they adopt the practice of hiding things in the fine print.[27]

5.50 Virgin Money advocated a standard disclosure mechanism for all credit cards, modelled on the 'Schumer box' used in the United States. Virgin Money considered that this standard mechanism, termed an 'honesty box' should be provided in all credit card promotional literature and should present information

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26 *Official Committee Hansard*, 16 May 2005, p. E1-2.

27 *Official Committee Hansard*, 16 May 2005, p. E4.

about interest rates, key fees and core terms and conditions of the card in a clear and easily understood manner. Virgin Money recommended that standardised disclosure requirements be mandated for all credit card providers.[28]

5.51 Other submissions also advocated improved disclosure requirements. FCAN submitted that both the interest rate and how that interest is charged be disclosed:

> For example a credit card and line of credit is charged daily and compounding. FCAN would like an explanation to the consumer of what that actually means, that your interest will be added each day and then the next day you will be charged interest on your balance plus the interest each day.[29]

### *Financial literacy programs*

5.52 There are mixed views about the importance of improving financial literacy to minimise the incidence of financial distress in the community and the misuse of credit. The Australian Bankers' Association told the Committee that the banking industry saw improving financial literacy as essential, and had taken a number of significant initiatives to improve it:

> Yes, we certainly do provide information to the community and to our customers about the best way to borrow and manage money. We do have a fairly comprehensive financial literacy program in place for both the industry and our individual banks…We are firm believers that the best borrowers are the best informed borrowers. It makes sense for us to lend money to people who understand what they are getting themselves into and can pay it back. Financial literacy is a very big issue for us.[30]

5.53 The FCAN agreed that financial literacy is lacking in Australian society and told the committee there are moves to have financial literacy included in some school curriculums. While acknowledging that moves to increase financial literacy are a positive initiative, the FCAN cautioned that literacy programs do not address the adult population's needs in this area, and that it is also necessary to address how financial products are marketed:

> It is important to curb the marketing of financial products in light of the fact that there are some in society who don't have enough financial literacy to make a sound judgement.[31]

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28 Virgin Money, *Submission 7*, pp. 2, 9.

29 FCAN, *Submission 1*, p. 2.

30 *Official Committee Hansard*, 16 May 2005, p. E71.

31 FCAN, *Submission 1*, p 2.

5.54 The CCLC was more critical, stating that financial literacy is not the answer to consumer debt:

> As a general rule consumers do not enter unmanageable debt because of ignorance. They may have an unrealistic appreciation of their capacity to repay, or an overly optimistic view of their employment prospects. These tendencies have perhaps more to do with personality types than financial sophistication.

5.55 The CCLC saw the life circumstances of people who encountered difficulties with consumer debt as more important. They advised the committee that in their experience, the people who had problems with debt tended to be those whose circumstances had changed (unemployment, illness etc) and those who have restricted choices because of their personal situation. The CCLC maintained that financial literacy would make little difference in respect of either group.[32]

### *Mandating assessment of ability to repay debt*

5.56 Several of the consumer credit groups that made submissions or gave evidence put forward recommendations for addressing the shortcomings they considered existed in the credit industry.

5.57 The CCLC submitted that in relation to credit and charge cards, the following principles should be incorporated in the Consumer Credit Code or other appropriate legislation:

- that lenders should undertake a proper credit assessment in relation to each credit contract, or variation of credit contract, they enter to ensure that the borrower(s) has the capacity to meet their contractual obligations;
- that the above credit assessment should be based on the borrowers ability to repay the facility if it is fully drawn within a reasonable period (say under 30 years for home loans and under 5 years for all other forms of consumer lending)
- that automatic penalties apply to the lender for failure to comply with the above provisions including financial penalties for the lender in addition to relief from the relevant debt for the affected borrower; and
- the ability to market using credit limit increase offers be curtailed in situations where the borrower's repayment patterns indicate a predefined level of financial difficulty.[33]

5.58 CARE Financial Services advocated the national extension of the approach adopted in the ACT, noting that the ACT was the only jurisdiction which had moved to require credit providers to assess ability to pay:

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32 CCLC, *Submission 6*, p. 14.

33 *Submission 6*, p. 13.

> In the ACT, credit providers are now required to assess a consumer's capacity to repay the credit being offered before it is advanced on new credit cards, or through offers of increased credit on pre-existing cards.[34]

5.59 The CCCL recommended amending the Consumer Credit Code to include a requirement for credit providers to undertake a proper credit assessment in relation to each credit contract that the borrower enters. The CCCL also considered that a proper credit assessment should also be required when the borrower or credit provider seeks to increase the amount of credit available under the contract. Like CARE (ACT), the CCCL saw the approach adopted in ACT legislation as offering a model for change:

> The 'satisfactory assessment process' defined in the ACT *Fair Trading Act* would be a useful place to start in formulating an appropriate obligation. Introducing such an obligation is not a novel approach. It is already enshrined in limited scope in the ACT and, in a slightly different form, for subscribers to the *Code of Banking Practice*.[35]

5.60 While consumer legal groups consider that inadequacies in lending practices are at the root of most of the problems in the credit industry, lenders and credit bureaus maintain that a significant part of the problem is that they are forced to operate in an information–poor environment, and are forced to take much of what applicants for credit say to them at face value. Several groups took the opportunity presented by this inquiry to call for a change in credit reporting. This proposal, known as positive credit reporting, would require changes to the Privacy Act.

### *Positive credit reporting*

5.61 The Committee received two submissions[36] advocating a change in Australia's consumer credit reporting system as a means of addressing issues of unsustainable and unaffordable household debt. These submissions focus on the role of the credit reporting system in the lending process. They put the view that a change in the type of information that consumer credit bureaus can hold will have a positive impact on manageable levels of household debt in Australia and will lead to a more efficient allocation of financial resources. Proponents also maintain that this change would lead to sounder lending practices, particularly in relation to credit cards.

5.62 On the other hand, consumer advocates are concerned that industry calls for positive credit data are based on self-interest and if successful will lead to more opportunities for the industry but will not increase prudent lending, nor decrease

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34 Care Financial Counselling Service, *Submission 2*, p. 4.

35 CCLC, *Submission 6*, p. 10.

36 Dun & Bradstreet (Australia) Pty Ltd, *Submission 14*, and MasterCard International, *Submission 15*.

default rates. Furthermore, they argue that the industry has not operated a fair and accurate limited credit reporting regime to date and existing problems can only be made worse by increasing the amount of information that the industry is permitted to gather.

*Background*

5.63 There are three main credit reporting agencies (credit bureaus) in Australia: Baycorp Advantage, Dun and Bradstreet and Tasmanian Collection Service. Baycorp Advantage is the largest.

5.64 Credit bureaus store credit data that is used to generate credit reports. Credit providers such as banks and telephone companies subscribe to credit bureaus and can request information from them about people's credit history.[37] This information supplements their own data gathered from credit applications as well as that acquired through past experience with an applicant.

5.65 Credit in Australia is regulated by the states and territories but Part IIIA of the Privacy Act governs consumer credit reporting. Part IIIA sets down rules about who is allowed to access credit reports, the type of information that can be held by credit bureaus and the uses to which a report can be put. Generally, it also prohibits disclosure by credit providers of credit worthiness information about an individual and provides rights of access and correction for individuals as regards their personal information.

5.66 Australia's existing system of credit reporting is described as a 'negative' credit reporting system. The information that credit bureaus may currently record about individuals is listed below:[38]

- full name, including any known aliases, sex and date of birth;
- a maximum of three addresses consisting of a current and last known address and two immediately previous addresses;
- name of current or last known employer;
- driver's licence number;

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[37] Common credit providers are banks, building societies and credit unions. However credit providers also include:

- businesses that issue store credit cards, eg department stores; and
- businesses that provide a good or service and allow payment to be deferred, for example, telephone, gas and electricity companies, video hire shops, furniture stores and car hire businesses.

[38] Office of the Federal Privacy Commissioner, *Privacy Act: Fact sheet 7*, viewed on 21 September 2005, at: http://www.privacy.gov.au/publications/crda.html#3.

- a record of a credit provider having sought a credit report to assess an application for consumer or commercial credit;
- default information (information may only be included here if the individual is at least sixty days overdue and the credit provider has taken steps to collect the amount outstanding); and
- certain items of publicly available information such as court judgments and bankruptcy orders.

5.67 Bureaus may only hold information about credit applications, overdue accounts (over 60 days) and court judgments on individual files for five years from the date of listing. They may keep information about bankruptcies or serious credit infringements on file for seven years from the date of listing.

5.68 Additional information that might be put in reports if the legislation were amended includes:

- a person's credit limits;
- the balance of credit accounts; and
- any delinquency patterns in payment.

5.69 In relation to credit cards, it could also allow the recording of details of all cards held by an individual, potentially addressing possible problems associated with a person being issued with further cards without the lender knowing what other cards the borrower holds.

### *Argument for positive credit reporting*

5.70 In its submission, MasterCard International highlighted the role played by information asymmetries that exist between lenders and borrowers in hampering the efficiency of credit markets. It suggests that the resulting inefficiencies impose high costs on both the financial industry and consumers in the form of lower returns for the former and higher costs in getting credit for the latter.[39]

5.71 While the availability of negative credit information partially addresses the information asymmetry, MasterCard considers that it is only when positive information is also available that the asymmetry will be closed. It characterises positive information as the following:

> …information related to prospective borrowers' outstanding debt obligations, types of credit and their histories, even when the borrower has never defaulted or gone bankrupt.[40]

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[39] MasterCard, *Submission 15*.

[40] *Submission 15*.

5.72 Citing research about the experience in Europe, MasterCard suggests that the availability of positive credit information leads to a lowering of the credit risk inherent in credit markets. MasterCard attributes a reduction in US mortgage rates by up to two percentage points to the securitisation of mortgages which depends on the use of positive credit information. (The Committee notes that there has been a similar reduction in mortgage rates variously attributed to securitisation of mortgages in Australia which were possible without positive credit information being available)

5.73 According to Dun and Bradstreet, the Australian system does not allow for credit bureaus to record whether credit applications have been approved, and in the event that they have been, to what limit. Neither is there any information recorded on an individual's capacity to pay.[41] Dun and Bradstreet is concerned that the system limits a lender's ability to determine a consumer's capacity to service debt. It provides the following example:

> …a consumer who is struggling to make ends meet but is still managing to pay-off the minimum amount on existing loans can continue to increase his/her credit levels, because credit bureaus can only report on whether the consumer has defaulted on payments and not on the consumer's real capacity to meet further credit commitments.[42]

5.74 Furthermore, a minor default during the previous five years can prevent people from accessing affordable and serviceable credit even when they have a recent good payment history and their circumstances are significantly different to those in which they incurred the default. This is because the individual's credit report will only show a prior payment default.[43]

5.75 In relation to finding solutions to problem household debt, Dun and Bradstreet believes that there must be a focus on the decision-making process that underpins a lender's capacity to make responsible, sustainable and affordable lending decisions. This approach would be preferable to one in which there is an exclusive focus on lending practices which it considers would anyway likely improve, by reform of the consumer credit reporting system. In its submission it cites studies and a number of overseas experiences that it says point to a link between the credit reporting system, sustainable credit growth and lower default rates.[44]

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41 Dun and Bradstreet, *Submission 14*, p. 6.

42 *Submission 14*, p. 6.

43 *Submission 14*, p. 7.

44 *Submission 14*, pp 9–11.

5.76 Dun and Bradstreet recommends that credit bureaus should be permitted to store the following additional data on individuals:

- the name of each current credit provider;
- the type of each current credit account;
- the date on which each current credit account was opened; and
- the limit of each current credit account.

5.77 It is keen to point out that this additional data would not constitute a shift to the USA-style 'full-file' positive consumer credit reporting system as it does not provide the extensive information that is currently allowable in the United States of America.[45]

*Argument against positive credit reporting*

5.78 Except for the two submissions referred to above, the Committee did not receive any sustained comment from others as to the merits or otherwise of changing the credit reporting system.[46] This is not surprising as the issue is not specifically canvassed in the Committee's terms of reference and is peripheral to the main inquiry.

5.79 However, material from the print and related media suggests that there is significant disquiet from consumer advocates about the notion that credit providers could gain access to additional information about consumers.[47] These advocates are sceptical about the size of any benefits flowing from positive credit reporting and believe that they are unlikely to outweigh the potential risks for consumers.[48]

5.80 Additionally, one of the benefits of a positive credit reporting system put forward by the industry, is that it would enable providers to lend more money. In the light of the currently high level of household debt in Australia and the low level of savings, the Committee questions whether this would necessarily be of benefit to the community. During its inquiry the Committee found no evidence to suggest that

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45 Dun and Bradstreet, *Submission 14*, p. 8.

46 However, Anglicare Financial Counselling Service, Tasmania (*Submission 10*, p. 3) advocated that, along with restrictions on credit practices and other measures, a review of the merits of positive credit reporting should be undertaken.

47 Australian Consumers' Association, *Credit reporting: mistaken identity and other stories*, viewed on 23 February 2005, at: http://www.choice.com.au/printFriendly.aspx?ID=104159; Catherine Wolthuizen, 'Open sesame', *Consuming Interest*, Spring 2004, pp 15-17; Letter to the editor, Australian Financial Review, *Self-interest gags credit reporting*, Catherine Wolthuizen, Australian Consumers Association, 18 February 2005, p. 79.

48 Nicola Howell, Consumers' Federation of Australia, *Expanding the credit reporting system – A summary of consumer concerns*, July 2003.

a lack of availability of credit was a problem for the majority of consumers in this country, and indeed the reverse appears to be true.

*Senate Legal and Constitutional References Committee Report*

5.81 The Senate Legal and Constitutional References Committee recently reported on the Privacy Act. As part of its inquiry that Committee considered Part IIIA of the Act.[49] The report found significant shortcomings in the operation of Part IIIA and the Committee took the view that additional funding must be provided to the Office of the Privacy Commissioner to enable it to fulfil its regulatory oversight function. For a more detailed discussion of these issues, the Committee refers the reader to that report.

5.82 The Legal and Constitutional References Committee also considered positive credit reporting in its report. It recommended that the Privacy Act not be amended to allow the introduction of positive credit reporting in Australia.[50] Its recommendation was based on the following reasoning:

> The committee sees no justification for the introduction of positive credit reporting in Australia. Moreover, the experience with the current range of credit information has shown that industry has not run the existing credit reporting system as well as would be expected and it is apparent that injustice can prevail. As mentioned elsewhere in this report, positive reporting is also rejected on the basis that it would magnify the problems associated with the accuracy and integrity of the current credit reporting system. The privacy and security risks associated with the existence of large private sector databases containing detailed information on millions of people are of major concern.[51]

*Committee views*

5.83 The question of whether governments should intervene in relation to credit card debt is difficult to resolve. While there is a significant minority within the community who lack financial literacy or the skills necessary to manage their credit commitments, there is no convincing evidence that these problems are widespread. Imposing a further regulatory burden on finance providers requires careful judgements to be made about whether further regulation is justified. A balance has to be struck between protecting consumers' interests and allowing the market to operate competitively and efficiently.

5.84 Ultimately it must also be accepted that there will always be some people in the population that it is impossible to protect from either their own lack of

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49 Legal and Constitutional References Committee, *The real Big Brother: Inquiry into the Privacy Act 1988*, June 2005.

50 *The real Big Brother: Inquiry into the Privacy Act 1988*, p. 160.

51 *The real Big Brother: Inquiry into the Privacy Act 1988*, pp 159-160.

prudence or from taking desperate action driven by the circumstances in which they find themselves.

5.85 However, the Committee is persuaded that some of the lending practices within the credit and charge card industry that have been described during the inquiry are sub-standard and are not in accordance with the standards of practice which the banking industry itself regards as acceptable.

5.86 In particular, the Committee is concerned that the practice of offering consumers unsolicited increases in credit limits without conducting a thorough appraisal of whether there is capacity to pay is unsound, and consumers are not provided with information about interest rates, and conditions of use in a form that is sufficiently user friendly.

5.87 In relation to the issue of positive credit reporting, this committee is not persuaded to take a different view to that expressed by the Legal and Constitutional References Committee. The Committee does not believe that credit providers are making full use of the information currently available to them. Further, as observed previously in this chapter, defaults and other signs of financial distress in the credit card market are very low and do not justify the very significant change that would be required for positive credit reporting to be introduced. The Committee does not consider that any further parliamentary inquiry into this matter is justified at this time.

**Recommendation 7**

**The Committee recommends that the States and Northern Territory develop and pass uniform consumer credit legislation requiring credit providers to undertake appropriate checks of borrowers' capacity to pay before issuing new credit cards or raising credit limits. The ACT Fair Trading Act provides an appropriate model for this legislation.**

**Recommendation 8**

**The Committee recommends that the Consumer Credit Code be amended to mandate the provision, in a clear and easily understood manner, of a summary of the interest rates, key fees and core terms and conditions of card interest rates in all credit card promotional literature. This requirement is also to apply to charge cards and interest free periods offered by retailers.**

Senator Ursula Stephens
**Chair**

# GOVERNMENT SENATORS' COMMENTS

## General remarks

1. Government Senators welcome this Report. They do not, however, concur with all of its findings or reasoning.

2. The relatively high level of the current account deficit, and of household debt, are (as participants in the Committee's Roundtable acknowledged) to a significant extent the result of high levels of consumer demand. This, in turn, has been stimulated by the very strong economic conditions which the Australian economy has enjoyed over the past decade, characterized by historically low inflation, low interest rates, low unemployment, high wages and salaries and sharp growth in household wealth. During the past decade, Australia has enjoyed golden economic conditions which are the envy of other comparable nations.

3. One of the consequences of the macroeconomic conditions described in the last paragraph is that, while debt levels have been relatively high, debt service costs have remained relatively low. This is, in the most immediate and obvious way, the effect of low interest rates. But the capacity and willingness of Australian households to take on and service more debt is also the product of a strong labour market, in which wage and salary earners can look forward to secure jobs with relatively high levels of wages and salaries.

4. Australian households spend because they have a greater capacity to do so than has historically been the case, and a greater capacity to go into debt in order to facilitate spending, both on capital assets and on consumer goods. This has inevitable consequences both for household debt and for the current account deficit, as households increase the volume of expenditure on imported goods.

5. Government Senators do not disagree with Recommendations 1, 5 and 6. They do not agree with Recommendation 4.

## Government policies to encourage exports

6. Government Senators consider that the implicit criticism of the Government contained in Recommendations 2 and 3 is unwarranted and unsupportable. The suggestion, in Recommendation 3, that the Government should "introduce policies designed to bring about an improvement in the medium-to-long term average of the current account deficit", and to "increase … international competitiveness of the export sector" borders on the absurd in suggesting that the current Government (and, indeed, its predecessors) do not already do so. Disappointingly, the discussion in the Report prefacing Recommendations 2 and 3 show little if any awareness of the broad range

of specific policies and initiatives by the Australian Government for that very purpose.

7. The Government provides a business environment that supports strong economic growth and profitability across the board, including in the manufacturing sector. The Government is also supporting Australian industry through direct budgetary and tariff assistance. The Productivity Commission estimated that the manufacturing sector received $6 billion of budgetary and net tariff assistance in 2003-04. Much of this assistance is to promote the development of elaborately transformed manufactures (ETMs) such as automotive goods. Information on the key programs to promote the development of ETMs and services is outlined below.

8. Government Senators draw to the attention of the Committee the following programs, both industry-specific and general, which the Majority Report has apparently disregarded in arriving at Recommendations 2 and 3. The list is not exhaustive

***General Programs***

*Commercial Ready*

Commercial Ready supports innovation and its commercialisation. It provides over $200 million per year in competitive grants to small and medium-sized businesses to support a wide range of project activities, extending from initial research and development (R&D), through proof of concept to early-stage commercialisation activities.

*Commercialising Emerging Technologies (COMET)*

COMET supports early-growth stage and spin off companies to successfully commercialise their innovations. COMET helps customers commercialise innovation through: raising capital from business angels or venture capital funds; borrowing money; licensing; and joint ventures or strategic alliances.

*Certain Inputs to Manufacture (CIM)*

The CIM Program provides import duty concessions on certain imported raw materials, intermediate goods as well as prescribed metal materials and goods. The goods must be intended for use in export enhancement or import replacement activities that would generate a quantifiable and significant benefit to Australia.

*Innovation Investment Fund (IIF)*

The IIF promotes the commercialisation of Australian research and development, through the injection of venture capital into small, high-tech companies in their seed, start up or early expansion stage.

*Pooled Development Funds*

The PDF program is designed to increase the supply of equity capital for growing Australian small and medium-sized enterprises. PDFs are private sector investment companies established under the PDF Act which raise capital from investors and use it to invest in Australian companies.

*Research and Development (R&D) Tax Concession*

The R&D Tax Concession is a broad-based, market driven tax concession which allows companies to deduct up to 125% of qualifying expenditure incurred on R&D activities when lodging their corporate tax return. A 175% Incremental (Premium) Tax Concession and R&D Tax Offset are also available.

*Industry Cooperative Innovation Program*

The Industry Cooperative Innovation Program is a $25 million commitment to encourage business-to-business cooperation on innovation projects that enhance productivity, growth and the international competitiveness of Australian industries.

*New Exporter Development Program (NEDP)*

The New Exporter Development Program (NEDP) is designed to assist small and medium sized Australian companies develop their business overseas and make their first export sale. The NEDP provides a wide range of free services to new exporters including advice and information about getting into exporting, export coaching and assistance on the ground in foreign markets.

*The Export Market Development Grants (EMDG)*

The Export Market Development Grants scheme is the Australian Government's principal financial assistance program for aspiring and current exporters. The scheme is administered by Austrade and is aimed at encouraging small and medium sized Australian businesses to develop export markets by reimbursing up to 50% of export promotion expenses above $15,000.

*Export Finance and Insurance Corporation (EFIC)*

The Export Finance and Insurance Corporation (EFIC) provides competitive finance and insurance services to Australian exporters and Australian companies investing in new projects overseas. EFIC provides medium to long-term finance facilities to the buyers of Australian exports, or to their financiers, to assist with the purchase of exports, usually capital good and/or services rather than commodities or other consumables.

*Small Business Enterprise Culture Program*

The Small Business Enterprise Culture Program aims to develop and enhance the business skills of small business owner-managers and demonstrate the contribution that such skills can make to business viability and growth. It will achieve this by providing competitive grants for initiatives designed to enhance small businesses access to skills development and mentoring.

*Small Business Incubator Program*

The Small Business Incubator Program provides funding to organisations to help meet the infrastructure and set-up costs of new small business incubators. Smaller amounts are also provided for feasibility studies and to existing incubators for enhancements. Small business incubators assist start-up and developing new businesses by providing shared premises and business services, as well as intensive business advice and support. Tenant businesses are provided with an initial place of operation and a supportive environment in which to grow their business, before graduating into the wider business community.

*National Innovation Awareness Strategy*

The Strategy was established to raise awareness in the community and in small to medium sized business enterprises of the importance and benefits of innovation, entrepreneurship and commercialisation.

*Innovation Awareness Grants*

The Grants provide support for activities and initiatives that foster entrepreneurship and awareness of the benefits of innovation across Australia.

*Action Agendas*

Action Agendas encourage firms to export, invest and innovate more in response to the dynamic Australian economic environment. They help

industries develop strategies for growth, agree on priorities, and commit to change. Action Agenda industries work with government on priorities for reform in areas such as education and training, workplace relations, regulations, innovation and cutting red tape.

Thirty-six industries have been covered by Action Agendas, covering one third of GDP and employment, 50% of exports and 75% of R&D expenditure. Over 500 industry and business people have been engaged in industry leaders' groups for Action Agendas, with a further 500 in working groups. Many of the ETM industries have been covered including marine industries, science industry, medical devices, electronics, pharmaceuticals, food and aerospace.

### *Industry-specific Programs - Manufactures*

*Automotive*

The Automotive Competitiveness and Investment Scheme (ACIS) commenced in 2001. It is designed to provide transitional assistance to encourage competitive investment and innovation in the Australian automotive industry in the context of trade liberalisation. ACIS is expected to deliver an estimated $7 billion to the Australian automotive industry over the period 2001 to 2015.

The ACIS Motor Vehicle Producer Research and Development Scheme (MVP R&D Scheme) will run for the duration of ACIS Stage 2 (2005-2010 inclusive). It is expected to cost $150 million and aims to increase the amount of research and development undertaken by motor vehicle producers in Australia. All motor vehicle producers registered as ACIS participants are eligible to take part in the MVP R&D Scheme.

*Textiles, Clothing and Footwear*

The Textiles, Clothing and Footwear (TCF) TCF Post-2005 (SIP) Scheme is a ten-year scheme to foster the development of a sustainable and internationally competitive TCF manufacturing industry and TCF design industry in Australia by providing incentives which will promote investment and innovation. The Scheme provides for two grant types which provide subsidies for capital expenditure and innovation activities.

*Pharmaceuticals*

The Governments $150 million Pharmaceuticals Partnerships Program will support an additional $500 million (over 2004-05 to 2009-10) of high quality R&D in Australia by originator, generic and biotechnology companies. By supporting the portfolio of R&D undertaken by a company and its related bodies corporate, the program supports

company growth and adds to critical mass which can help anchor manufacturing activity in Australia.

*Joint Strike Fighter*

Under the Joint Strike Fighter (JSF) Program the Australian Government and Australian companies are working together to secure opportunities to supply high technology aerospace components to the next generation of air combat fighter aircraft being developed by Lockheed Martin in the US. Under the JSF Program to date, Australian companies have been successful in winning US$60 million in work. In winning this work, Australian companies have accessed a wide range of Government programs including a number from the suite of R&D Programs and the sector specific programs.

***Industry–specific Programs – Services***

*Tourism*

The primary support by the Government’s tourism portfolio for exports is via global destination marketing undertaken by Tourism Australia.
In addition, policy impediments to export are identified and addressed in market-specific strategies, including in Action Plans for Korea (now in implementation) and Japan (to be developed in next 90 days), and in the Emerging Markets Strategy (initially China and India).

The Department of Industry, Tourism and Resources also engages with other Departments and agencies in addressing generic policy impediments to tourism export growth including in the areas of aviation security, immigration, customs, quarantine, education and training, environment and heritage, and export market development assistance via EMDGS.

Air access for international visitors is given particular focus in the National Tourism and Aviation Advisory Committee, and in the portfolio's engagement on specific air services negotiations and in policy reviews including the impending Review of Aviation (the Pacific Route).

The Department also funds programs stimulating supply in niche and regional tourism (Australian Tourism Development Program), cultural tourism (Tourism Indigenous Business Ready Program and Indigenous Tourism Australia) and eco-tourism (Tourism and Conservation Partnerships).

The Department assists in protecting the brand reputation of Australia's tourism exports by funding the establishment of a tourism business and

accreditation portal, funding the development of a code of conduct for tour guides, administering the industry aspects of the China Approved Destination Status scheme and developing for the Government's consideration a national approach to the protection of tourism quality.

The Department coordinates tourism sector preparedness for external shocks through its stewardship of the National Tourism Incident Response Plan and integration with whole-of-government coordination of disaster preparedness (as presently in train for avian flu).

*Financial Services*

Axiss Australia has been established to position Australia as a global financial services centre in the Asian time zone. Axiss assists financial services companies who are considering establishing or expanding their activities in Australia, provides advice to Government on policy, regulatory and market structure issues, and acts as a conduit between the private and public sectors on matters affecting Australia's development as a global financial services centre.

**Obligations of Credit Providers**

9. Government Senators generally support Recommendation 7, although they do not consider that the ACT *Fair Trading Act* necessarily provides the only template for uniform legislation.

10. In particular, Government Senators are persuaded that under current laws, there is insufficient transparency in the cost of credit. They therefore strongly support Recommendation 8, and urge the State and Territory Governments to legislate accordingly.

Senator George Brandis
**Deputy Chair**

Senator Grant Chapman

# Appendix 1
# Submissions Received

| Submission Number | Submittor |
|---|---|
| 1 | Financial Counsellors' Association of NSW Inc (FCAN) |
| 2 | Care Financial Counselling Service (CFCS) |
| 3 | Australian Prudential Regulation Authority (APRA) |
| 4 | Australian Manufacturing Workers' Union (AMWU) |
| 5 | Australian Bureau of Statistics (ABS) |
| 6 | Consumer Credit Legal Centre (NSW) Inc (CCLC) |
| 7 | Virgin Money (Australia) Pty Ltd |
| 8 | Australian Merchant Payments Forum (AMPF) |
| 9 | Dr David Morrison |
| 10 | Anglicare Tasmania Inc |
| 11 | Centre for Credit and Consumer Law<br>Griffith University |
| 12 | Banking and Financial Services Ombudsman Limited |
| 13 | The Treasury |
| 14 | Dun & Bradstreet Australasia (D&B) |
| 15 | MasterCard International |
| 16 | Australian Bankers' Association |
| 17 | ANZ |
| 18 | Debt Helpline Pty Ltd |

# Appendix 2
# Public hearings and witnesses

**Monday, 16 May 2005 - Sydney**

**BELL**, Mr David Peter, Chief Executive Officer, Australian Bankers Association

**CHRISTIAN**, Ms Christine, Chief Executive Officer, Dun and Bradstreet Australasia

**CONROY**, Mr Pat, National Projects Officer
Australian Manufacturing Workers Union

**COX**, Ms Karen, Coordinator, Consumer Credit Legal Centre (New South Wales) Inc

**GAMBLE**, Mr Rohan, Managing Director, Virgin Money (Australia) Pty Ltd

**HOSSACK**, Mr Nicholas, Director, Prudential Payments and Competition Policy
Australian Bankers Association

**LANE**, Ms Katherine, Principal Solicitor
Consumer Credit Legal Centre (New South Wales) Inc

**NAFFAH**, Mr Albert, Director
Strategic Business Development and Regulatory Affairs, MasterCard International Inc

**Monday, 15 August 2005 – Canberra – Round Table**

**GARNAUT**, Professor Ross Gregory, Professor of Economics
Division of Economics, Research School of Pacific and Asian Studies
Australian National University

**GRUEN**, Dr David William Roy, Chief Adviser (Domestic), Macroeconomic Group
Department of the Treasury

**HAWKINS**, Mr John Robert, Manager, Domestic Economy Division
Department of the Treasury

**PEARSON**, Mr Anthony George, Head of Australian Economics, ANZ

**POTTER**, Mr Michael, Director of Economics and Taxation
Australian Chamber of Commerce and Industry

**SIMES**, Dr Richard Mark, Private capacity

# Appendix 3

# Relationship between the current account deficit and foreign liabilities[1]

Australia has nearly always had a deficit on its current account, although it wasn't until the 1980s that these deficits were associated with a build up of foreign debt (borrowings). Earlier deficits were not associated with a build up of debt because the deficits were generally lower and the capital inflow to finance these deficits was largely in the form of long-term equity investments. From the early 1980s, however, Australia experienced persistently high current account deficits (CAD) and almost all the capital inflow needed to finance these deficits was in the form of overseas borrowings.

While current account deficits contribute to a nation's net foreign liabilities, the CAD for a given period does not have to equal the change in net foreign liabilities that occurred over that period. For example, in round figures in 2004-05 the current account deficit totalled $57 billion, but net foreign debt (borrowings) increased by $35 billion and net foreign equity increased by $11 billon, giving a total increase in net foreign liabilities of $46 billion over that 12 months.

### *The Valuation Effect*

A current account deficit in a given period is equal to the change in net foreign liabilities (i.e. debt plus equity) that occurred over that period minus the valuation effects. Valuation effects, which can be substantial, are those changes in the value of net foreign liabilities that are due to exchange rate movements and equity revaluations (mainly revaluations of issued shares and securities purchased by overseas investors).

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1 Appendix 3 is largely based on Research Note No. 40 of 29 April 1996, titled *Relationship between the current account deficit and foreign debt* published by the Department of the Parliamentary Library. The figures in the original Research Note have been updated from ABS *Balance of Payments and International Investment Position*, Cat. 5302.0.

Table 1 illustrates the relationship between the current account deficit in 2004-05 and the change in net foreign liabilities that occurred during that 12 months.

**Table 1: Relationship between CAD and net foreign liabilities**

| | Changes in levels June Qtr 2004 to June Qtr 2005 | | |
|---|---|---|---|
| | Total ($m) | Valuation effects ($m) | Capital transactions (total less valuation effects) ($m) |
| Net equity liabilities | 11052 | 9003 | 2049 |
| *plus* | | | |
| Net foreign debt | 35284 | -18316 | 53600 |
| *equals* | | | |
| Net foreign investment position | 46336 | -9313 | 55651 |

| | **2004-05** ($m) |
|---|---|
| Financial account surplus | 55651 |
| *plus* | |
| Capital account surplus | 1200 |
| *plus* | |
| Net errors and omissions | 320 |
| *equals* | |
| Current account deficit | 57171 |

From the figures in Table 1, Australia had a financial account surplus of $55 651 which, after adjustments, resulted in a CAD of $57 171 million in 2004-05. That deficit was financed by an inflow of $53 600m in debt (borrowings) and $2 049m in equity investment. The valuation effects during the 12 months totalled -$9 313m, so the increase in Australia's net foreign liabilities was $46 336m.

In theory a current account deficit should equal the capital account surplus, but in practice these items are rarely in balance and equality has to be achieved by a balancing item, called 'errors and omissions' in Table 1.

It should also be noted that just as current account deficits can affect the level of Australia's net foreign debt, so the cost of servicing this debt can add directly to our current account deficit by increasing the income deficit.

Table 2 shows the value of the components involved in calculating the increase in net foreign debt (borrowings) since 1988-98. Table 3 shows the same process for net foreign equity. Table 4 shows how net foreign debt and net foreign equity added to net foreign liabilities or Australia's net international investment position (i.e. basically the total of Tables 2 and 3).

Table 5 shows the adjustments made to the CAD each year to arrive at the Financial Account Surplus figure.

Note that the figures in Table 1 are in $ millions, but in Tables 2, 3, 4 & 5 are in $ billions rounded to the first decimal point.

## Effect of Revisions on the Size of the Current Account Deficit

The monthly balance of payments estimates are often subject to considerable revision.

Revisions may occur for a number of reasons, including:

- revisions to estimates provided by a data source;
- estimates from a more timely but less accurate data source are replaced by estimates from a different, less timely but more accurate data source;
- improvements in the method of compiling the balance of payments estimates from the data source; and
- changes in the concepts underlying the estimates.

A study of the monthly current account deficit figures published over the 10 years June 1986 to June 1996 found that initial estimates were lower than the later estimates on 55 occasions and greater than the later estimates on 66 occasions. So there was not a great difference in the frequency with which first estimates of the current account deficit are either underestimates or overestimates. Moreover, the size of the revision was about the same, being on average $219 million for a revision upward to the current account deficit and $212 million for a revision downward to the current account deficit.

**Table 2: Components of Annual Increase in Net Foreign Debt (borrowings), $billion**

| | Net foreign debt at beginning of period | Transactions | Valuation effects | Net foreign debt at end of period | Total increase in net debt |
|---|---|---|---|---|---|
| 1988-89 | 96.5 | 14.9 | 2.6 | 114.0 | 17.5 |
| 1989-90 | 114.0 | 16.1 | 0.8 | 130.8 | 16.8 |
| 1990-91 | 130.8 | 6.7 | 5.7 | 143.2 | 12.3 |
| 1991-92 | 143.2 | 13.6 | 5.7 | 162.5 | 19.3 |
| 1992-93 | 162.5 | 7.9 | 7.1 | 177.5 | 15.0 |
| 1993-94 | 177.5 | 4.6 | -10.7 | 171.3 | -6.1 |
| 1994-95 | 171.3 | 19.4 | 0.05 | 190.8 | 19.5 |
| 1995-96 | 190.8 | 10.0 | -6.9 | 193.9 | 3.1 |
| 1996-97 | 193.9 | 12.6 | 2.2 | 208.6 | 14.8 |
| 1997-98 | 208.6 | 5.1 | 14.0 | 227.8 | 19.2 |
| 1998-99 | 227.8 | 13.7 | -10.8 | 230.7 | 2.9 |
| 1999-00 | 230.7 | 37.9 | 4.1 | 272.6 | 42.0 |
| 2000-01 | 272.6 | 5.2 | 24.7 | 302.5 | 29.9 |
| 2001-02 | 302.5 | 38.0 | -16.3 | 324.2 | 21.7 |
| 2002-03 | 324.2 | 45.9 | -12.2 | 357.9 | 33.7 |
| 2003-04 | 357.9 | 51.8 | -15.0 | 394.7 | 36.8 |
| 2004-05 | 394.7 | 53.6 | -18.3 | 430.0 | 35.3 |

Source: ABS, *Balance of Payments and International Investment Position* (Cat. No. 5302.0)

**Table 3: Components of Annual Increase in Net Foreign Equity, $billion**

| | Net foreign equity at beginning of period | Transactions | Valuation effects | Net foreign equity at end of period | Total increase in net equity |
|---|---|---|---|---|---|
| 1988-89 | 31.3 | 1.9 | 2.8 | 36.0 | 4.71 |
| 1989-90 | 36.0 | 4.9 | 1.2 | 42.0 | 6.0 |
| 1990-91 | 42.0 | 9.2 | -2.8 | 48.3 | 6.31 |
| 1991-92 | 48.3 | -1.4 | -3.2 | 43.7 | -4.6 |
| 1992-93 | 43.7 | 6.0 | -6.1 | 43.7 | 0.0 |
| 1993-94 | 43.7 | 12.2 | 8.9 | 64.8 | 21.1 |
| 1994-95 | 64.8 | 9.0 | -9.1 | 64.7 | 0.1 |
| 1995-96 | 64.8 | 7.9 | 8.9 | 81.4 | 16.6 |
| 1996-97 | 81.4 | 5.0 | -4.9 | 81.5 | 0.1 |
| 1997-98 | 81.5 | 19.5 | -31.9 | 69.2 | -12.3 |
| 1998-99 | 69.2 | 16.4 | 5.4 | 91.0 | 21.8 |
| 1999-00 | 91.0 | -6.8 | -28.0 | 56.1 | -34.9 |
| 2000-01 | 56.1 | 11.1 | -4.1 | 63.1 | 7.0 |
| 2001-02 | 63.1 | -18.8 | -3.2 | 41.0 | -22.1 |
| 2002-03 | 41.0 | -5.6 | 34.9 | 70.3 | 29.3 |
| 2003-04 | 70.3 | -5.9 | 11.4 | 75.8 | 5.5 |
| 2004-05 | 75.8 | 2.1 | 9.0 | 86.9 | 11.1 |

Source: ABS, *Balance of Payments and International Investment Position* (Cat. No. 5302.0)

**Table 4: Net international investment position at end of period, $ billion**

| | Net foreign debt (borrowings) | Net foreign equity | Net international investment position |
|---|---|---|---|
| 1988-89 | 114.0 | 36.0 | 149.9 |
| 1989-90 | 130.8 | 42.0 | 172.8 |
| 1990-91 | 143.2 | 48.3 | 191.5 |
| 1991-92 | 162.5 | 43.7 | 206.2 |
| 1992-93 | 177.5 | 43.7 | 221.1 |
| 1993-94 | 171.3 | 64.8 | 236.1 |
| 1994-95 | 190.8 | 64.7 | 255.5 |
| 1995-96 | 193.9 | 81.4 | 275.3 |
| 1996-97 | 208.6 | 81.5 | 290.2 |
| 1997-98 | 227.8 | 69.2 | 296.9 |
| 1998-99 | 230.7 | 91.0 | 321.7 |
| 1999-00 | 272.6 | 56.1 | 328.8 |
| 2000-01 | 302.5 | 63.1 | 365.6 |
| 2001-02 | 324.2 | 41.0 | 365.1 |
| 2002-03 | 357.9 | 70.3 | 428.1 |
| 2003-04 | 394.7 | 75.8 | 470.5 |
| 2004-05 | 430.0 | 86.9 | 516.8 |

Source: ABS, *Balance of Payments and International Investment Position* (Cat. No. 5302.0)

**Table 5: Adjustments involved in calculation of the current account deficit and the financial account surplus, $ billion**

| | Financial account surplus | Capital account surplus | Net errors and omissions | Current account deficit |
|---|---|---|---|---|
| 1988-89 | 16.9 | 2.0 | 0.2 | 19.0 |
| 1989-90 | 20.9 | 2.0 | -0.1 | 22.7 |
| 1990-91 | 15.9 | 2.1 | -0.5 | 17.5 |
| 1991-92 | 12.1 | 2.1 | -1.0 | 13.3 |
| 1992-93 | 13.9 | 0.6 | 0.6 | 15.1 |
| 1993-94 | 16.8 | 0.3 | -1.0 | 16.1 |
| 1994-95 | 28.4 | 0.6 | -0.6 | 28.4 |
| 1995-96 | 17.8 | 1.1 | 2.6 | 21.5 |
| 1996-97 | 17.6 | 1.3 | -1.3 | 17.6 |
| 1997-98 | 24.6 | 1.1 | -3.0 | 22.8 |
| 1998-99 | 30.1 | 1.2 | 2.3 | 33.6 |
| 1999-00 | 31.1 | 1.1 | 0.5 | 32.6 |
| 2000-01 | 16.3 | 1.1 | 0.8 | 18.2 |
| 2001-02 | 19.2 | 1.0 | 0.9 | 21.1 |
| 2002-03 | 40.3 | 1.0 | 0.3 | 41.6 |
| 2003-04 | 45.9 | 1.1 | 0.8 | 47.8 |
| 2004-05 | 55.7 | 1.2 | 0.3 | 57.2 |

Source: ABS, *Balance of Payments and International Investment Position* (Cat. No. 5302.0)

# Appendix 4

## Concluding remarks of participants in the Round Table Canberra, 15 August 2005

At the conclusion of the Round Table discussion on 15 August 2005 on issues related to the current account, the Chair invited the six professional economists to make concluding remarks. Their remarks are reproduced in full here, as they provide a good summary of their different viewpoints on the subject of this inquiry.

The economists who participated in the Round Table were (in alphabetical order):

- Professor Ross Garnaut, Professor of Economics, Division of Economics, Research School of Pacific and Asian Studies, Australian National University.
- Dr David Gruen, Chief Adviser (Domestic), Macroeconomic Group, Department of the Treasury
- Mr John Hawkins, Manager, Domestic Economy Division, Department of the Treasury
- Mr Anthony Pearson, Head of Australian Economics, ANZ Banking Group
- Mr Michael Potter, Director of Economics and Taxation, Australian Chamber of Commerce and Industry
- Dr Richard Simes, Vice President CRA International (appearing in a private capacity)

Professor Garnaut:

> When the current account deficit as a share of GDP gets as large as it has recently in Australia, especially when that is at a time of unusually favourable external circumstances—and I have drawn attention to the high terms of trade and the low international interest rates—then it is time to carefully analyse whether we are vulnerable to a deterioration of circumstances. We may be lucky. This may be the first huge increase in the terms of trade in our long history on this island continent which has not suffered a significant reverse, and I hope that that is the case, but we would prepare ourselves better for the possibility of reversal if we were doing a number of the things that have been discussed in this meeting. If, while we are assuring ourselves that the improvement in the terms of trade is permanent, we have governments run larger surpluses; and if, while we are assuring ourselves that the very low international interest rates that Alan Greenspan has described as a conundrum are a permanent feature of the international environment, we are a little cautious in our fiscal policy, and if we run hard to remove the many remaining impediments to high productivity, including in the export industries, then the risks of us

suffering a very painful adjustment, possibly including a recession if international circumstances deteriorate suddenly, will be significantly less.[1]

Dr Gruen:

I do not have much to add, but I will make one point. It is very hard to determine the extent to which Australia's vulnerability has been raised by the rise in net external liabilities. The extent to which that has made us more vulnerable is not at all obvious—to me, at least. I have certainly been surprised by the extent of resilience in the Australian economy over the last decade or so in a series of circumstances which, before they happened, I would have thought would cause us a lot of trouble but did not. If it is the case that the current account or the rise in external liabilities is a problem, then it is very much a medium-term problem rather than a short-term problem, and that makes me wary of tying macro policy to the current account. It seems to me that we have done extremely well by running macro policy with internal balance objectives, and the last time we used the current account as an excuse for running macro policy was in the lead-up to the early nineties recession, which I do not think was a huge success. So I do not think it is sensible to use macro policy to try and respond to the current account. To the extent that one wants to respond to the current account, I think you have to do as Dr Simes has argued, which is to try and do things to the underlying measures of savings—largely savings in the economy. Again, whether you need to do that is an open question, but, if you want to do something about the current account, that is where you should look.[2]

Mr Hawkins:

In a sense you could say that the problem with the current account is something like: you have nothing to fear but fear itself and that the current account becomes a problem if the markets decide it is a problem. I agree with the comments Michael [Potter] made that the indicators are that at the moment the market is not seeing it as a significant problem in Australia. There are reasons to say that our current account—around six per cent of GDP—is not as much of a risk as in past instances of current account deficits of that size because of the counterparts in the savings investment and because of the structure of the net liabilities.[3]

Mr Pearson:

In summing, up we did not address all the questions that were given to us. A lot of the thrust of the questions as we went through them concerned household borrowing, house price booms—things like that. I just want to put things in perspective a bit in that, particularly in terms of the house price phenomenon in Australia over the last seven years, we have not been

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1 Prof Garnaut, *Proof Committee Hansard*, 15 August 2005, p. E37.

2 Dr Gruen, *Proof Committee Hansard*, 15 August 2005, p. E37.

3 Mr Hawkins, *Proof Committee Hansard*, 15 August 2005, p. E38.

alone; we have been part of the global phenomenon. In fact, we have not even been a frontrunner by a country mile. We have roughly doubled house prices over seven years. In South Africa, they have gone up 3½ times. Britain and Ireland have had much bigger house price booms than we have. The global phenomenon we have been part of was because of the very low interest rates through 2000, 2001 and 2002. They were put in place to, in a sense, prevent the possibility of global recession in 2001. So we have been through a very unusual period around the world, and we have been part of that global phenomenon. It has not just been an Australian phenomenon, and I think that is worthy of focusing on.

That global phenomenon [housing bubble] is gradually running out of steam. It has pretty much ended in Australia, as we talked about earlier, with the possible exception of Perth. But basically national house prices have, over the last 18 months, been flat and are gradually decelerating generally around the world, with some other exceptions. I am just wondering whether some of these problems that we have focused on as being uniquely Australian and as having emerged recently are in fact part of global phenomena and that they will, to a certain extent, self-correct. I think that global perspective is worthy of some focus.

Having said that, I still believe that the current account deficit in Australia is, in large part, a trade problem, not a capital inflows problem. I believe the capital inflow is a consequence of the trade problem, not the cause of the problem. It appears that, over the last four years in particular, it is the export side that has been particularly weak, rather than that imports have been particularly strong. Imports have certainly been boosted to a certain extent, but the flatness in the volume of exports, I think, is of concern. To that extent, policy measures that could perhaps be directed at that trade side would, I think, help to moderate the current account concerns going forward. But I do believe that in the short term you will find some self-correction as this global phenomenon gradually cools.[4]

Mr Potter:

It has been a very valuable discussion this afternoon, and I thank you for inviting me along. I thank the rest of the panel for their contributions. One of the things I want to leave with the committee is that we do not think that the Australian economy is perfect. There are quite a number of issues around. We have touched on most of those—for example, the capacity constraints and the fact that exports have been reasonably flat until quite recently. Another point I will make is that labour productivity has fallen in the past four quarters, which I think is important, but I would not place too much weight on that because there are some definitional issues in that. There are other things going on, such as oil prices and China.

All of these are important issues that need to be dealt with, but we do not consider that the current account deficit is a problem in and of itself. If it is seen to be an issue, we think it is more a symptom of what is going on in

4 Mr Pearson, *Proof Committee Hansard*, 15 August 2005, p. E38.

> the underlying economy. It could be a symptom of some of those issues that I have just talked about. The two key reasons we think the CAD is not a problem are that, first of all, the rating agencies are saying that Australia is still rated very highly. The second thing is that the risk premium on Australian debt is still within quite manageable levels. I guess the onus of proof really has to be upon those who say the current account is a problem to explain why those measures are wrong and why the market is getting it wrong with assessing Australia's vulnerability.[5]

Dr Simes:

> I think I have indicated that I agree with Ross's [Garnaut] basic point. We should be concerned about the current account as such. I want to make one comment about the questions you asked about household debt. The level of household debt has obviously gone up. It has been associated with household wealth going up—that is, gearing has gone up a lot. If there is any policy response to it, we need to be careful not to undo something that has been really very positive in the economy—that is, financial deregulation has seen access to credit improve a lot; it has increased not only economic efficiency a lot but also equity. If you go back 20 years or more, access to credit was a big concern from an equity point of view—for example, in the Campbell committee report—and we need to make sure that the benefits are not unwound.[6]

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5 Mr Potter, *Proof Committee Hansard*, 15 August 2005, p. E36.

6 Dr Simes, *Proof Committee Hansard*, 15 August 2005, p. E37.

# Appendix 5

# Factors contributing to household debt

The evidence presented to the Committee focussed on housing related debt and credit card debt. Although opinions differ about impact of the various contributing factors, most commentators agree that the primary factors behind the strong growth in household debt levels include:

- Freeing up of the financial markets, which meant credit became much more readily available;
- A prolonged period of low inflation and low interest rates gave consumers a feeling of confidence in the economy;
- Increased competition in lending, more advertising and promotion;
- A much wider range of products from lenders, including lines of credit and interest-only loans;
- The stockmarket boom in the mid-to-late 1990's followed by the real estate boom and the ability of consumers to borrow for investment purposes;
- The growing acceptance of the concept of debt used for investment as 'good debt', actively promoted by financial advisers promoting wealth creation strategies based on investment in equities and property;
- Increasing financial literacy and the realisation of the baby boomer generation that it would have to take more responsibility for funding a comfortable retirement;
- Rising asset values, especially in residential real estate, which gave home owners a feeling of increased wealth (so-called 'wealth effect'), and the ability to unlock that wealth through new financial products such as loans based on home equity;
- A sustained period of economic growth, low inflation, low interest rates, and falling unemployment.

Treasury sees the rise in household debt as:

> …a rational response to the deregulation of the financial system, allowing consumers to smooth their consumption more efficiently over their life cycle…Lower inflation, leading to lower nominal interest rates, has also made it easier for households to borrow more.

Treasury stated that the increased ability to borrow (which is a function of both deregulation and lower interest rates) probably helped drive up house prices, increasing the amount that households needed to borrow.[1]

The ANZ bank had a similar view, stating that debt levels had been driven by 'a sustained boom in house prices, a sustained low interest rate environment and solid growth in household incomes'[2].

The RBA's view is that the main reason debt has risen is that households can afford to borrow more in a low interest rate environment. The Bank also points out that in a low inflation environment, the real value of loans is eroded more slowly than when inflation is high; and financial deregulation has played a significant role, increasing lender competition and providing innovations such as home equity loans and redraw facilities.[3]

All commentators agree that increased investor activity in the housing market has further increased demand in the market, contributing significantly to increases in housing prices and household debt levels.

Some commentators consider that banks and other finance providers may also have influenced demand by increasing the amount of money available to the market, aggressive promotion of lending products and allowing lending standards to slip in a bid to maintain profits and market share. This view is disputed by lenders who maintain that the borrowing is entirely driven by demand factors, which the lending institutions merely find more creative ways of satisfying.

Wealth effects, whereby households feel encouraged to spend on the basis of perceived increased wealth resulting from increased house prices, may also have had an effect on debt levels.

The rise in household debt is also partly attributable to the increase in the number of additional people who have borrowed money in response to the above factors. The RBA notes that the number of households with owner-occupied housing debt appears to have increased by over 40 per cent since 1996, considerably faster than the growth in the number of households.[4]

## The housing boom

As the Governor of the RBA observed in 2003:

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1 The Treasury, *Submission 13*, p. 7.

2 ANZ Bank, *Submission 17*, p. 1.

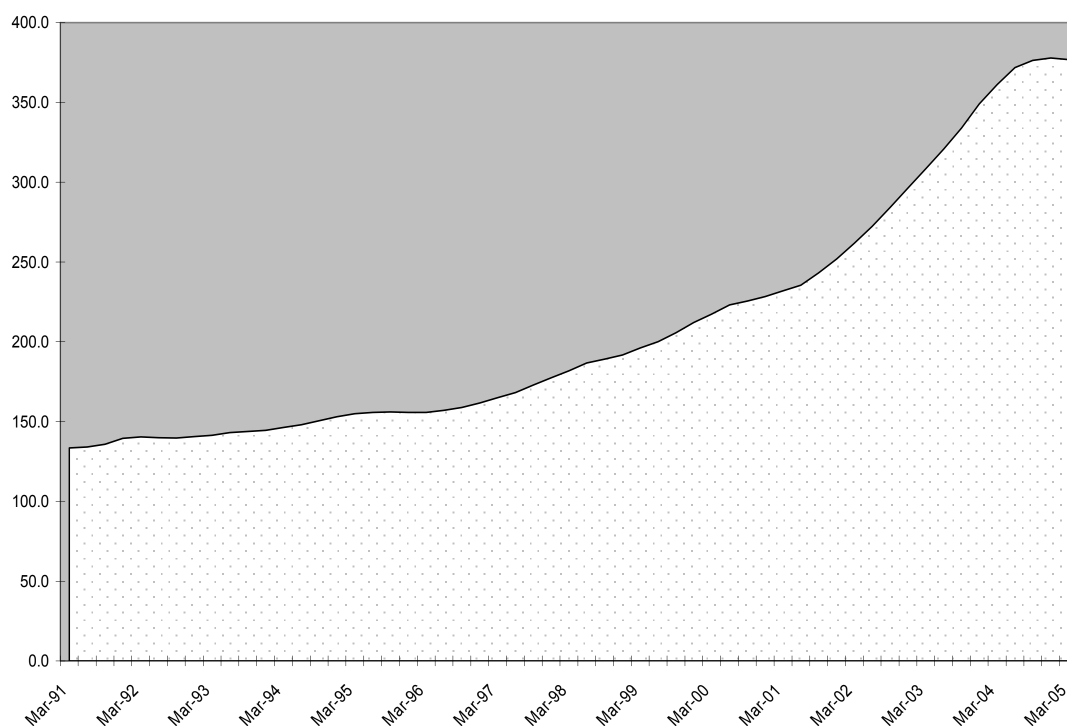
3 RBA, *Do Australian Households borrow too much?*, Speech by the Governor, Mr I.J. Macfarlane to the Sydney Institute, 3 April 2003.

4 RBA, *Financial Stability Review*, September 2005, p. 20.

> The story about household debt is largely a story about housing and, of course, is intimately tied up with the subject of rising house prices.[5]

Australian house prices are at a historical high, having more than doubled since 1996. This rise was particularly pronounced in the period between March 2001 and March 2004, with around 40 per cent of the rise in the last decade occurring in that period. Figure 1 below shows the rise in house prices since March 1991.

**Figure 1: Median Price Established Houses Sold ($000)**
**Weighted average 8 capital cities – average of previous 4 quarters**




Source: Parliamentary Library housing data derived from Real Estate Institute of Australia, *Market Facts*.

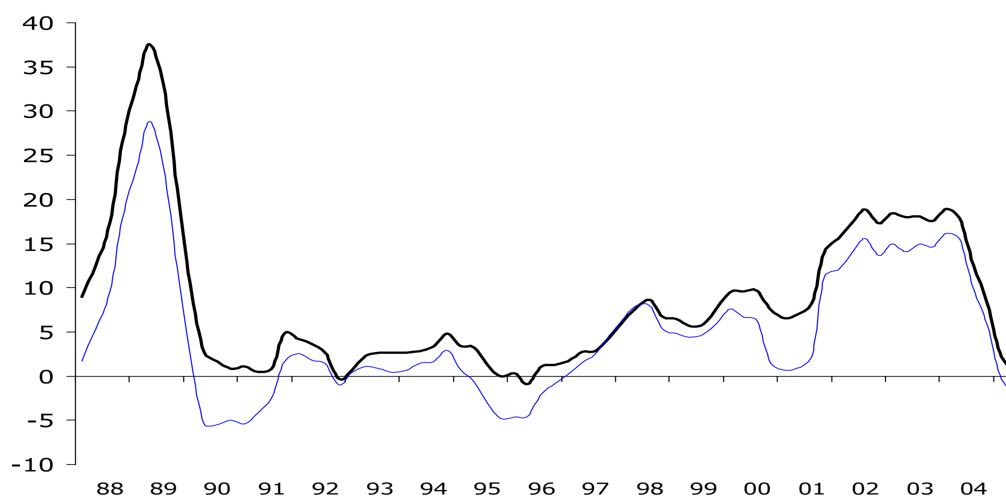
An alternative way of considering the increase in house prices is to compare how much these have changed from previous years. Figure 2 shows this change in prices as a percentage, expressed in nominal and real terms. The graph puts the recent increases in house prices in context, showing that this was not the first occasion when large price movements have happened.

In the massive boom of the late 1980s, prices increased in one year by 40 per cent. The rate of increase has been less during the current boom, but has been sustained over a long period. It has also been seen consistently across the country. As observed

5 RBA, *Do Australian Households borrow too much?*, 3 April 2003.

by the Productivity Commission, 'the upswing in housing prices since the mid-1990s has been bigger and more widespread than in previous cycles'[6].

**Figure 2: House prices over the last 17 years (Nominal and real terms) showing the percentage change from the previous year.**




Source: ABS, reproduced from Submission 17, ANZ Bank.

But why have house prices risen? Housing prices behave in accordance with the basic principles of supply and demand. Put simply, demand for housing forces prices up if supply falls short of what the market needs. During this boom, growth in demand has outstripped the growth in supply. Construction of new dwellings, while at very high levels, has not kept pace with the rise in the number of households and investors seeking to buy properties.

There is evidence that the boom in house prices has come to an end, and that a cooling off in the market is taking place. Treasury advised the Committee that the housing cycle is unwinding, and that as this market cools, growth in dwelling investment and consumer spending should ease and household saving rise.[7]

The RBA also believes that the boom in prices for housing has come to an end in most capital cities. In its August 2005 Statement on Monetary Policy, the RBA published the following table (Table 1), which shows a fall in Sydney prices and low or static prices except in Perth and Adelaide. A feature of this table is that the RBA is now able to publish statistics that are stratified by market segment, and are a more reliable indicator of what is happening in the market.

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6 Productivity Commission Inquiry Report, *First Home Ownership*, No. 28, 31 March 2004, Key findings.

7 The Treasury, *Submission 13*, p. 10.

**Table 1: Composition-adjusted house prices – percentage change**

| | 18 Months to Dec qtr 2003 | 18 Months to June qtr 2005 |
|---|---|---|
| Sydney | 25 | -7 |
| Melbourne | 20 | 0 |
| Brisbane | 62 | 5 |
| Adelaide | 35 | 9 |
| Perth | 33 | 19 |
| Canberra | 41 | 0 |
| Australia | 29 | 0 |

Source: RBA, *Statement on monetary policy*, August 2005.

The RBA also notes that lending for housing remains above its 2004 average, but has softened in recent months. While housing credit growth was still running at an annualized rate of 10.9 per cent in the six months to June 2005 this is half the peak rate of 2003.[8]

## Deregulation of the financial system

The most fundamental change that occurred as a result of the deregulation of the financial section was that instead of governments attempting to regulate the operation of financial markets through supply-side measures, demand became the main factor influencing the amount of money borrowed. This was well summed up by the Australian Bankers Association (ABA) in its submission:

> A central tenet of the financial sector deregulation achieved in Australia over the past two decades has been the removal of iniquitous credit rationing that had previously prevailed, thereby allowing policy to influence credit through demand-side factors. [9]

Deregulation had a number of significant effects, including:

- removal of restrictions on lending;
- increased competition between lenders, further enhanced by the entry of foreign banks and non-traditional lenders into the market; and
- innovation increased, leading to a much wider range of financial products becoming available to borrowers.

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8 RBA, *Statement on Monetary Policy*, 8 August 2005, pp. 28, 36.

9 ABA, *Submission 16*, p. 3.

Enhanced competition between lenders resulting from deregulation has also reduced borrowing costs by putting downward pressure on interest rates and operating margins. Treasury advised that competition within the sector has brought about a reduction of interest rate margins from 3.6 per cent in 1994 to 1.8 per cent in 2004.[10]

Competition encouraged innovation, leading to the introduction of financial products that are more flexible and can be tailored to the needs of a wider group of consumers, making them more attractive to borrowers. Developments in the mortgage market are a good example. Treasury advised the Committee that in 1980 there were 26 types of mortgages available and that deposit-taking institutions were the main source of home finance. By 2003, approximately 3000 differentiated mortgage products were available to consumers.[11]

A number of new institutions also now offer housing finance, although banks retain 85 per cent of the market. According to the ABA, about 10 percent of all home loans are now provided by non-conforming lenders, that is, lenders who are not subject to APRA's prudential supervision because they do not take deposits.[12] This group includes lenders such as mortgage originators, of whom Aussie Home Loans is a well-known example. Non-conforming lenders raise money by issuing securities in the money market to raise funds for lending, a process known as securitisation.

The ABA argued that while the market share of non-conforming lenders is still relatively small, its influence is considerable, and has led to the introduction into the banking sector of a number of new financial products such as 'low-doc' loans which originated in the non-conforming sector.[13]

Mortgage brokers have also entered the Australian housing market and have made a significant impact. Mortgage brokers are essentially middlemen between borrowers and lenders whose role is to find and arrange home loans for customers. The ABA told the committee that this group now represent about 30 per cent of the housing loan market, and their presence has exerted downward pressure on interest rates:

> …I understand that mortgage brokers constitute about 30 per cent of the market…As a result of financial deregulation initiated by various governments, mortgage brokers are a fact of life. They have certainly assisted in the downward pressure on interest rates and, I guess from a customer viewpoint, they have proven to be a good thing.[14]

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10 The Treasury, *Submission 13*, p. 11.

11 *Submission 13*, p. 11.

12 ABA, *Submission 16*, p. 7. It should be noted that securitisation is not used exclusively by non-conforming lenders. Securitisation is also used extensively by more traditional lenders. 17 per cent of all housing loans are now securitised, a modest figure compared to the USA where the figure is in excess of 60 per cent.

13 *Submission 16*, p. 9.

14 *Official Committee Hansard*, 16 May 2005, p. E68.

Other significant innovations in the housing loan market include mortgage insurance, which allows a lending institution to lend where income-to-repayment ratios exceed 30 per cent, or where the buyer has less than the required deposit; and home equity loans, which enable a home owner to access equity and can be used for a range of purposes including the purchase of property for investment purposes.

A natural consequence of deregulation is that finance is available to many more people, increasing demand. As Treasury pointed out in its submission, this increased ability to borrow has probably helped to drive up house prices, which in turn increased the amounts households needed to borrow.

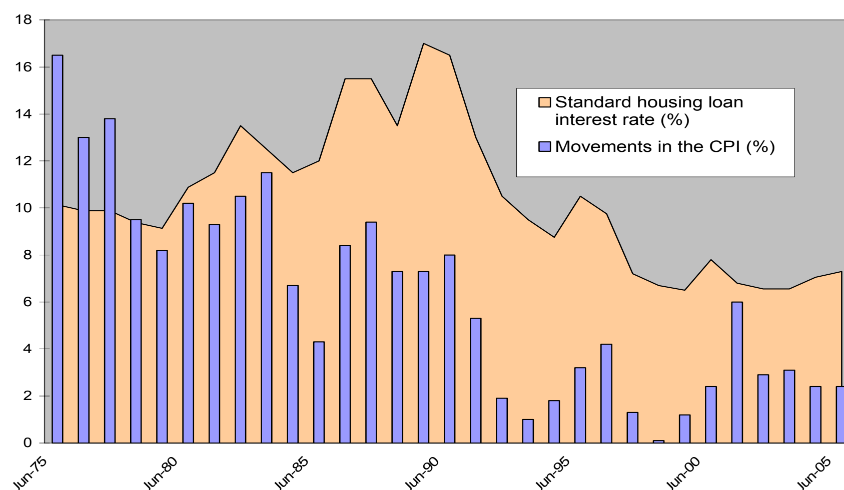
## Interest rates and inflation

Australian interest rates have declined steadily for the last fifteen years, and have been consistently low for most of the last decade. As shown in Figure 3, interest rates charged by the banks for housing mortgages declined steeply from their 1989 peak of 17 per cent, and have remained low by Australian standards for most of the last decade.

This reduction in interest rates has a close relationship with the decline of inflation. As Treasury noted in its submission to the inquiry, lower inflation, leading to lower nominal interest rates, has made it easier for households to borrow more. However this increased ability to borrow 'probably helped to drive up house prices, thereby increasing the amount households needed to borrow'.[15]

15 The Treasury, *Submission 13*, p. 7.

**Figure 3: Housing loan interest rate and movements in the CPI 1975 – 2005.**[16]




Source: RBA

A fall in interest rates also places mortgage finance within reach of a larger proportion of the population, some of whom would not have previously qualified for a loan under the income tests that lenders traditionally applied to borrowers.

The ABA advised the Committee that traditionally, the standard income test that a bank applies is that the monthly loan repayment should not exceed 30 per cent of gross income. Higher income individuals may qualify for a higher ratio. This income test is applied 'conservatively', incorporating an interest rate buffer of one or two per cent.[17]

The Productivity Commission quantified the increase in borrowing capacity that has resulted from lower interest rates in its report *First Home Ownership*, observing that average borrowing capacity over the last five years was about 70 per cent higher than for the period 1983 to 1993[18].

There is evidence that the increased affordability that results from low interest rates has also affected buyer preferences, and many previous home owners have traded up to better, larger homes in more desirable areas. New homes are also significantly larger on average than houses built a decade ago. In its report *First home ownership*, the Productivity Commission explains this effect succinctly:

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16 Derived from RBA data and statistics provided by Parliamentary Library.

17 ABA, *Submission 16*, p. 4.

18 Productivity Commission Inquiry Report, *First Home Ownership,* p. 44.

> For owner-occupiers, a halving of the interest rate almost doubles the mortgage potentially obtainable, as well as nearly doubling the price of a home that a home that can be 'afforded' for a given budget or income.[19]

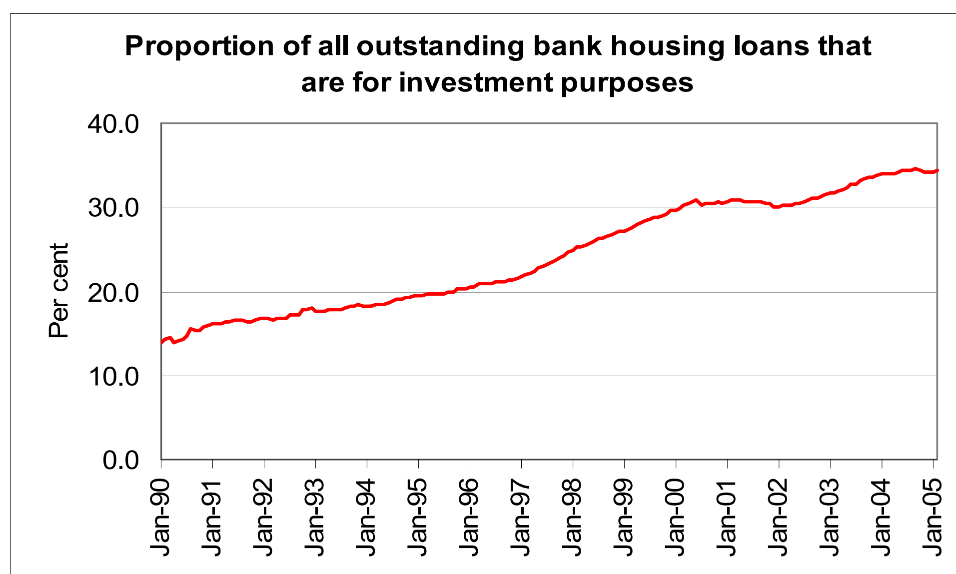
The RBA agrees that debt has risen because households can afford to borrow more, but points out that a low inflation environment also means that households hold their debt for longer. This is because the real value of the debt is not eroded as fast as it is in a high inflation environment. The RBA considers that these two factors (low interest and slower debt erosion) could account for an approximate doubling of the debt-to-income ratio.[20]

### Investor activity in the housing market

Significantly higher investment activity in the housing market is an important factor adding to housing demand. Investor activity increases buyer competition and, as a result, prices.

As shown in Figure 4, investment loans as a proportion of total outstanding housing loans have grown from around 15% in 1990 to about 34% in 2005. This growth has slowed in response to the softening of the property market since 2004.

**Figure 4: Proportion of bank housing loans for investment property.**




*Source: Reserve Bank of Australia Bulletins.*

19 Productivity Commission Inquiry Report, *First Home Ownership,* p. XVII.

20 RBA, *Do Australian Households borrow too much?*, Speech by the Governor, Mr I.J. Macfarlane, to the Sydney Institute, 3 April 2003.

While Australia (70%) has roughly the same rate of home ownership as the UK (69%), the USA (67%) and Canada (64%) it has a significantly higher rate of ownership of investment property. About 13% of Australian households receive rental income (up from about 9% a decade ago), compared with about 6.5% in both the USA and Canada, and 2% in the UK.[21]

The rise in property investment appears to have been driven by a number of factors, including:

- Perceptions that this is a profitable activity, anticipating capital appreciation;
- Taxation considerations (eg: negative gearing, favourable capital gains tax treatment);
- The availability of a range of diversified banking products particularly suited to investors (eg home equity loans); and
- Money more freely accessible as a result of financial sector deregulation.

The Productivity Commission identified a 'supportive' tax environment and aggressive marketing of property investment 'opportunities' among the factors that further stimulated the investor-driven component of the demand for housing.[22]

The RBA has expressed particular concern about the rise of investor activity in the housing market, warning that many people were more exposed to risk than they perhaps realised.

## Income and employment growth

A number of commentators, including the ANZ and the Productivity Commission, have identified rising household incomes and employment rates as contributing to rises in demand for housing and price rises.[23]

In its report *First Home Ownership*, the Productivity Commission pointed out that aggregate household income had increased in real terms by 2.8 per cent a year since 1992-93, while real disposable income increased by an average rate of 1.2 per cent per year.

In the same period, the number of people in full time jobs increased by approximately one million, an average increase of 1.5 per cent per year.[24]

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21 Productivity Commission Inquiry Report, *First Home Ownership*, pp. 22 & 33. According to the Australian Taxation Office's *Taxation Statistics* in 2001-02 there were 10 280 299 taxpayers of whom 1 337 520 (13 per cent) received rental income. The RBA reports that borrowing for property investment grew at an average of 21.6 per cent in the period 1993-2003, compared to 13.4 per cent for owner occupied housing; RBA, *Do Australian households borrow too much?*, p. 4

22 Productivity Commission Inquiry Report, *First Home Ownership*, pp. XVIII.

23 ANZ, *Submission 17*, p. 1.

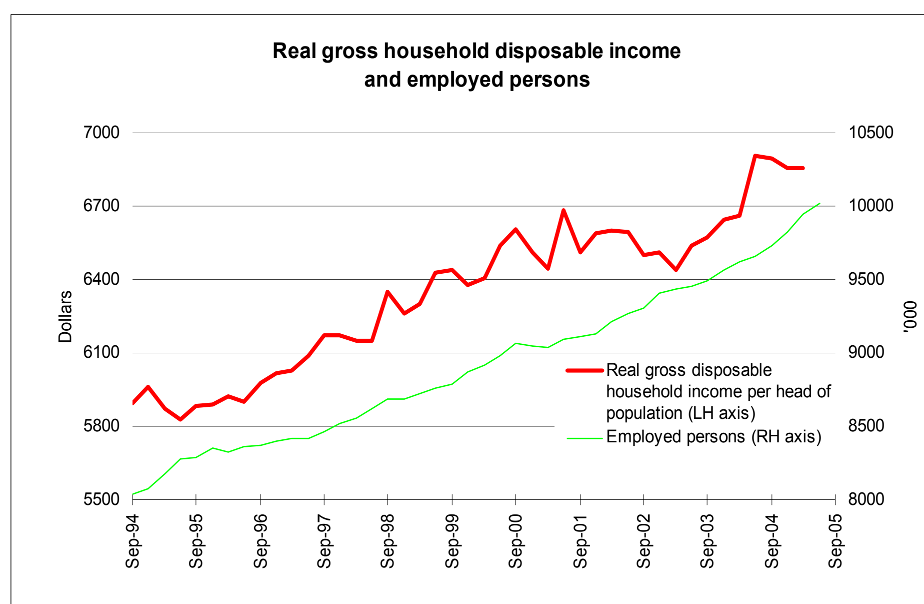
The Commission argued that as income and employment rise, more people have the capacity to purchase housing, and existing owners have increased capacity to trade up to higher quality housing if that is their preference.

The Commission's research indicated that the link between rising incomes and employment and rising house prices was significant, although difficult to disentangle from other demand side factors. However, it concluded that:

> Nevertheless, it seems incontrovertible that income and employment growth have underpinned growth in housing demand in Australia since the 1990s, which has in turn placed upward pressure on prices.[25]

Figure 5 shows the growth in incomes and employment over the last decade. While rising incomes may have added to the demand for housing, they have not kept pace with the rise in debt, which increased substantially relative to income.

**Figure 5: Growth in real income and employment 1994 – 2005**




Source: ABS

## Lending policies and practices of finance providers

There seems little doubt that the lending policies and practices of banks and other financial institutions contributed to increased demand for housing finance and thereby household debt. However, the extent of the impact which this had is debated. Chapter 5 of the report explores this area in more depth.

24 Productivity Commission Inquiry Report, *First Home Ownership*, p. 60.

25 Productivity Commission Inquiry Report, *First Home Ownership*, p. 61.

## Wealth effects

The housing boom of the past few years resulted in substantial wealth gains in many Australian households as existing houses were revalued upwards. The ANZ estimates that net household wealth has increased by 45 per cent over the last three years.[26] This increase in valuations has given rise to what commentators describe as a 'wealth effect', which is considered to have been a factor in increasing household debt.

The Governor of the RBA, Mr Macfarlane, described the wealth effect in the following terms:

> Recent evidence from several countries including Australia shows that during periods when house prices are rising rapidly households tend to react to this by increasing their consumption faster than their income—that is, they reduce their savings. They can do this either by reducing discretionary saving or by borrowing against the equity in their house to finance non-housing expenditure, a process referred to as housing equity withdrawal. This process occurred in Australia particularly in 2002 and 2003. [27]

The ANZ maintains that the wealth effect has both monetary and psychological dimensions. In a monetary sense, households whose property values have increased substantially are able to tap into that wealth through a range of new loan products such as home equity loans. From a psychological perspective, increases in property prices make households feel wealthier and more comfortable about dipping into savings or borrowing more.

The ANZ estimates that the wealth effect increased household consumption growth from 4.2 per cent to 6.2 per cent for the March quarter 2004, and observed that the impact of this effect takes up to 18 months to become fully reflected in household consumption.[28] The ANZ's observations are consistent with research by the RBA.

A research study conducted by the Economic Research Department of the RBA in 2003 confirmed that the wealth effect is significant in driving household expenditure, although the study did not extend to whether overall debt levels increased as a result. That study drew comparisons between stock market wealth and housing wealth:

> For our preferred model, a one dollar permanent increase in stock market wealth is estimated to increase annual consumption by 6 to 9 cents in the long run and a similar increase in housing wealth is estimated to increase consumption by around 3 cents. Since households' housing assets are more

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26 ANZ Economic Research, *Household consumption and the wealth effect*, June 2004. This section draws heavily on the ANZ's paper and also on RBA studies and statements on this effect.

27 Governor of the Reserve Bank, Mr I Macfarlane, House of Representatives Standing Committee on Economics, Finance and Public Administration, *Official Committee Hansard,* 12 August 2005, p. 3-4.

28 ANZ, *Household consumption and the wealth effect,* p. 2.

> than three times as large as stock market assets, our estimates imply that a one per cent increase n housing wealth has an effect on aggregate consumption that is at least as large as that of a one per cent increase in stock market wealth.[29]

A manifestation of wealth effects, the use of home equity loans, has been identified by the RBA as adding to the risks faced by those households who use them. Households are generally acknowledged as being most at risk early in the period of a loan, this risk being diminished as the principle is repaid and incomes rise. The RBA has pointed out that in a low inflation environment, households stay in this risk zone for longer because incomes rise more slowly. The use of equity loans can further prolong the risk period as the principle may be topped up from time to time instead of being paid out.[30]

The RBA considers that the wealth effect may have dissipated somewhat as a result of recent developments in the housing market:

> In a world where dwelling prices have stopped rising and even declined somewhat, perceptions of ongoing rapid increases in wealth are presumably now in the process of dissipating. This will weaken positive wealth effects, and could possibly lead to a partial reversal in time. On the other hand, the earlier increases in dwelling prices were very large, and even with the latest data showing declines, a big cumulative rise in wealth has occurred over the past decade, most of which has not been tapped. So there may yet be some expansionary impetus in the pipeline from those earlier gains.[31]

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29 RBA discussion paper, *Housing Wealth, Stock Market Wealth and Consumption: A panel analysis for Australia*, Nikola Dvornak and Marion Kohler, July 2003.

30 See RBA, *Do Australian households borrow too much?*, p. 4.

31 RBA, *Economic Conditions and Prospects*, Speech by Mr Glen Stevens, Deputy Governor, 2 June 2004.