# AUSTRALIAN MANUFACTURING WORKERS' UNION

**SUBMISSION TO THE**
**SENATE ECONOMICS REFERENCES COMMITTEE**
**INQUIRY INTO POSSIBLE LINKS BETWEEN HOUSEHOLD DEBT, DEMAND FOR IMPORTED GOODS, AND AUSTRALIA'S CURRENT ACCOUNT DEFICIT**

**FEBRUARY 2005**

## Introduction

1. The Australian Manufacturing Workers' Union (AMWU) welcomes the invitation to make submissions to the Senate Economics Committee regarding the possible links between household debt, demand for imported goods and Australia's current account deficit.

2. The full name of the AMWU is the Automotive, Food, Metals, Engineering, Printing and Kindred Industries Union. The AMWU represents approximately 140,000 workers in a broad range of sectors and occupations within Australia's manufacturing industry.

3. The AMWU is very concerned in relation to the historic levels of household debt, the flood of imports entering the nation and the unprecedented run of current account deficits.

4. This submission discusses a number of specific concerns the AMWU has in relation to the build up of household debt. These concerns include:

    - The aggregate amount of debt.
    - The policies of the Reserve Bank and the banking sector that has contributed to this debt explosion.
    - The flood of imported goods purchased through greater household debt.
    - The effect of this on Australia's chronic current account deficit.
    - The extreme risks this poses to households and the Australian economy.

**5.** The AMWU's submission concludes by proposing policy solutions to the current debt crisis. This involves addressing Australia's persistent external imbalance and developing sustainable drivers of economic growth.

## Current Levels Of Household Debt

6. The absolute level of household debt is historically high, as is the household debt to income ratios. The current stock of consumer household debt is over $230 billion. This represents an exponential increase from as recently as 1996 when it was $60 billion[1].

7. Consumer spending has increased by $110 billion over the five years to 2004. Total earnings have risen by only $77 billion. The balance has come from running down savings and by taking out debt.

8. In June 1995 Australian households had an average debt of $40,029 and assets of $261,576. By June 2001, average debt had blown out to $71,243 - a 13% annual average rise - while assets grew by only 7.2% annually, to $374,582. Household debt then represented 105% of disposable income. By June 2003 it had reached 135%, making those two years the fastest period of debt accumulation in the past

[1] National Institute of Economic and Industry Research, "The dynamics of growth in Australia's 'lend and spend' economy", August 2003, p.12

23 years. Today it is slightly more than 140%. It will take every cent we earn for one year and three months to repay the money[2].

9. Some of this is borrowing against the increased value of housing assets, other debt has been racked up on credit cards – outstanding balances have more than quadrupled from $6.6 billion to $27.7 billion between March 1996 and March 2004.[3]

10. Household savings as a share of household disposable income has fallen from 14% in 1983, when the Hawke Government was elected, to 6% in 1996 to **negative** 3% in 2004.

11. Household debt to income ratios, by contrast, gradually rose from 35% to 50% between 1976 and 1990, but since then has grown exponentially to 75% by 1996 to 150% in 2004.

12. The Australian household debt servicing ratio has returned to the levels that prevailed just before the 1991 recession which is the historical peak benchmark of 25 % of discretionary income.[4]

13. By 1996, households had started to borrow considerable sums for consumption expenditure with $13 billion being borrowed which equalled 4 % of net disposable income. The level of the borrowing gap steadily increased to the 2001 fiscal year, when it is estimated to have reached 6 % of disposable income. However, over the last two years the borrowing gap has accelerated. For 2001-02 it is estimated at $45 billion and the estimate for 2002-03 is around $50 billion or 11 % of disposable income.[5]

14. The current situation is extremely worrying. The share of consumer debt in total household debt has gone from 16% at the end of the 1980s to 35% by March quarter 2003. That is, the debt explosion can not be solely attributed to increased borrowing to purchase costlier assets (i.e. housing)[6]. Instead the main driver of the debt explosion has been to purchase consumer goods. A practice that the AMWU submits is not sustainable.

15. This jump in household debt occurred partly due to the housing asset bubble. This debt explosion was the major driver of Australian economic growth in the last 5 years.

16. The AMWU believes that this boom was a mixed blessing for Australian workers, benefiting those who own their own property outright but hurting younger workers and cutting home affordability. In 1996, 43% of people owned their own home

---

2 Weekes, P., "Life after debt", Sydney Morning Herald, 26/1/05

3 Bramble, T., "Contradictions in Australia's 'miracle economy'", journal of Australian Political Economy, No. 54, December 2004, p.16

4 National Institute of Economic and Industry Research, "Growth or stagnation: Constructing an alternative scenario for Victorian manufacturing in the new millennium", a report prepared for the MICC, October 2001, p.67

5 National Institute of Economic and Industry Research, "The dynamics of growth in Australia's 'lend and spend' economy", August 2003, p.12

6 Ibid., p.11

outright, with 28% paying it off. By 2001, the figures had changed to 38% and 32% respectively. The proportion of 25-39 year olds who own their own home has fallen by 10 percentage points in this time.[7]

## The Factors That Contribute To Household Debt Levels

17. The most significant factor contributing to household debt levels have been the share and housing price bubbles.

18. Over the first half of the 1990s the ratio of gross household wealth (financial assets plus value of dwelling stock) to household incomes was between 4.8 to 5.0. After that date the ratio has steadily increased to 6 by March quarter 2003. The increase in household wealth this represents is around $500 billion, compared to the case if the rate had stayed at 5.0. It is this increase in wealth that has given the incentive and ability of households to embark upon consumer debt driven growth.

19. The rapid increase in housing prices, over the last decade in general and the last two years in particular, has been channelled into increased consumption by:

    i) general positive wealth effects on consumption expenditure;
    ii) allowing households to increase mortgage loans against their increased home value where the proceeds have been used for consumption;
    iii) allowing households to trade down in housing units and spend the difference on consumption; and
    iv) allowing households to maintain a sustained non-taxable income flow by trading in houses.

20. Poor monetary policy is to blame for the current precarious position of the Australian economy. A major cause of Australia's current economic problem has been the failure of the monetary authorities to adopt the rules of monetary policy used by the European Central Bank (ECB).

21. The first principle of ECB monetary policy is to use interest rates to control the growth of credit in the economy (represented by m3). The target growth of credit equals the product of the desired growth in GDP and inflation giving a growth of m3 of between 4 and 5% per annum.

    *"The monetary authorities in Australia have adopted a laissez faire approach to credit growth. Between 1995 and 2003 loans advanced by banks has expended by 13 % per annum. The ECB would regard such a policy as reckless. They would be right. Australia will pay a high penalty for pursuing such an approach."*[8]

22. The situation is inexplicable in that the monetary authorities appear to have learnt little from the lessons of the 1980 decade. The Reserve Bank's failure to adopt

---

[7] Bramble, T., "Contradictions in Australia's 'miracle economy'", journal of Australian Political Economy, No. 54, December 2004, p.15

[8] National Institute of Economic and Industry Research, "The dynamics of growth in Australia's 'lend and spend' economy", August 2003, p.11

credit targeting was a major cause of the 1991 corporate "balance sheet" recession. The 1990 decade saw no change in policy despite the lessons.

## The Extent To Which Demand For Imported Goods Contributes To Household Debt Levels

23. There has been massive growth in consumption expenditure funded by borrowing. The change in the borrowing gap (the difference between income and consumption financed by new consumer debt) has been the main stimulus to GDP growth and import demand.

| **The Australian household sector - borrowers and consumption[9]** | | | | |
|---|---|---|---|---|
| **Year** | **Household Borrowing Gap ($ billion)** | **Borrowing gap as % of household disposable income** | **Consumer debt direct stimulus to economy** | **Consumer Debt Impact on GDP** |
| 1989-90 | 5.6 | 2.3% | – | – |
| 1990-91 | -3 | -1.2% | -4.6% | -2.2% |
| 1991-92 | -2.6 | -1.0% | 1.4% | -0.7% |
| 1992-93 | -2.9 | -1.1% | -0.9% | -0.5% |
| 1993-94 | 4.4 | 1.6% | 3.1% | 1.7% |
| 1994-95 | 9.3 | 3.1% | 1.3% | 1.9% |
| 1995-96 | 12.7 | 4.0% | 1.5% | 1.8% |
| 1996-97 | 11.6 | 3.5% | -0.5% | 0.4% |
| 1997-98 | 17.2 | 5.0% | 2.1% | 1.3% |
| 1998-99 | 14.8 | 4.1% | -1.7% | -0.3% |
| 1999-00 | 24 | 6.2% | 3.8% | 1.9% |
| 2000-01 | 25.4 | 6.0% | -1.0% | 0.7% |
| 2001-02 | 45 | 10.3% | 6.3% | 4.0% |
| 2002-03 | 50.3 | 11.1% | 2.0% | 2.6% |

24. This explosion in debt funded consumption has led to very strong import growth.

9 National Institute of Economic and Industry Research, "The dynamics of growth in Australia's 'lend and spend' economy", August 2003, p.1

| Import Growth 1990-2004 | | | |
|---|---|---|---|
| | **Imports[10] - $ million** | **Annual Growth** | **GDP Growth[11]** |
| 1989-90 | 68 771 | | |
| 1990-91 | 66 948 | -2.65% | -0.1% |
| 1991-92 | 69 269 | 3.47% | 0.3% |
| 1992-93 | 79 077 | 14.16% | 3.7% |
| 1993-94 | 85 396 | 7.99% | 3.9% |
| 1994-95 | 97 654 | 14.35% | 4.2% |
| 1995-96 | 101 078 | 3.51% | 4.3% |
| 1996-97 | 103 590 | 2.49% | 3.8% |
| 1997-98 | 118 482 | 14.38% | 4.5% |
| 1998-99 | 126 456 | 6.73% | 5.3% |
| 1999-00 | 140 811 | 11.35% | 3.8% |
| 2000-01 | 153 205 | 8.80% | 2.0% |
| 2001-02 | 154 573 | 0.89% | 3.9% |
| 2002-03 | 167 169 | 8.15% | 3.0% |
| 2003-04 | 167 275 | 0.06% | 4.0% |

*Source: International Trade in Goods and Services, ABS (5368.0)*
*National Income, Expenditure and Product, ABS (5206.0)*

25. Over the term of the Howard Government, the value (in Australian dollars) of consumer goods imported has risen by 133.5%, of capital goods by 73.4%, and of intermediate goods by 48.7%. **As a result, the total outlay on imports has shifted over time towards non-value creating items (i.e., consumer goods) relative to goods necessary to fuel capital accumulation.**[12]

26. Imported consumer goods have risen by 133.5% over the last 8 years. However household income has not risen by anything near this amount. Hence there has been an increase in the borrowing gap to finance the consumption of imported goods.

## The Extent To Which Demand For Imported Goods By Australian Households Contributes To The Current Account Deficit

27. Over the last 8 years, and especially the last 4, the current account deficit has worsened significantly. The most worrying aspect of this trend has been the shift towards importation of consumer goods rather than capital goods. As discussed above most of this increased demand for imported consumer goods has been driven by increased household debt.

---

[10] Balance of Payments definition. Monthly figures are seasonally adjusted

[11] Quarterly figures are seasonally adjusted.

[12] Bramble, T., “Contradictions in Australia’s ‘miracle economy’”, journal of Australian Political Economy, No. 54, December 2004, p.20

28. Nowhere has this been more apparent then in the importation of elaborately transformed manufactures(ETMs), for example prestige cars, electronic goods etc… The trade deficit in ETMs stands at $75.4 billion as of the 2003-04 financial year.

29. Unfortunately import growth has not been curtailed. By March quarter 2003 merchandise imports reached 19.1% of GDP. In the mid 1990s the gap between manufactured exports and imports as a percentage of GDP was between 3 and 4% of GDP. By March quarter 2003 the gap had increased to almost 10% of GDP.

30. The current account is once again drifting out of control, at $12 billion per quarter, equivalent to six percent of GDP, up from $3.3 billion as recently as the September 2001 quarter.

31. This is comparable to the deficit in 1986, when Treasurer Paul Keating declared that Australia was at risk of becoming a 'banana republic'.[13]

32. Between 2001 and 2004, drought, rapid appreciation of the dollar, general cheapening of manufactured imports led to ballooning current account deficit through an 8% decline in the dollar value of rural exports, a 9.2% decline in resource exports and a 3.6% decline in manufactured exports[14].

33. Meanwhile, the rising Australian dollar has made imported manufactured goods more attractive. Theoretically, this need not have any impact on the balance of merchandise trade if volume rise is no faster than the decline in Australian dollar price (i.e. if price elasticity of demand (PED) is unity or less). However, the PED for manufactured imports is significantly greater than unity. That is, as imports get cheaper our demand for them increases more rapidly than the reduction in their price (i.e. say if imported DVDs cost $10, we would buy 1. If PED is unity or 1 if the cost of the DVDs fell to $5, we would buy 2 [hence the value of the imported goods is still $10]. However, in reality we are more likely to buy more than 2 if the price falls to $5). The result has been an increase in the value of manufactured imports across the board, especially for consumer goods, where the value of imports rose by 27.5% between June 2001 and June 2004.

34. As discussed in paragraph 24, the driver of the explosion in import growth and hence the disastrous current account deficits has been demand for consumer goods. Over the term of the Howard Government, importation of consumer goods has grown twice as fast as the growth in capital good imports. That is, it is the demand for imports by Australian households, not businesses, that has driven the present series of catastrophic current account deficits.

35. Consumer debt driven growth has a perverse effect on the balance of payments. It increases the current account deficit but creates a net capital account surplus. That is, to fund our consumption of imported goods, we borrow money from overseas.

[13] Bramble, T., "Contradictions in Australia's 'miracle economy'", journal of Australian Political Economy, No. 54, December 2004, p.18

[14] Ibid., p.19

This places upward pressure on the exchange rate at the same time as increasing the current account deficit. It is a recipe for long term structural disequilibrium.

36. This imbalance has led to worrying comparisons with the 1980s consumption boom and subsequent bust. Professor Garnaut has stated:

    *"The large, negative contributions of net exports were the main contributor to the increase in the current account deficit as a share of GDP, to close to the highest levels on record in both episodes. This is a startling comparison, since the need to reduce this deficit was the main reason put forward for the extreme monetary tightening that precipitated the recession of 1990-91, and today's deficit brings forth neither policy response nor substantial comment from the authorities."*[15]

37. In the short term, a current account deficit means that Australian living standards are being propped up by borrowing from foreign institutions (or by selling reserves of foreign currency).

38. At the end of the 1980s the stock of non-resident liabilities held by Australian banks was $19 billion. By March 2003 the level of liabilities had reached $183 billion. The increase was $164 billion. The increase in the stock of household consumer debt over the period has been $200 billion. Thus, the mechanism to allow the consumer debt driver to sustain itself for so long has had the ability of the banking system in a deregulated environment to borrow on foreign capital markets to lend to households for consumption expenditure.

39. Australia's foreign debt rose from $245 billion in December 1999 to $394 billion in June 2004, or from 40.4% to 48.5% of GDP. All of this is accounted for by private debt, public debt having been effectively eliminated over the past decade.

40. In the late 1980s foreign debt was two thirds of total Australian obligations. However, asset sales to foreigners, partly driven by privatisation of public assets, reduced the debt share of foreign obligations to less than 60%.

    *"This reduction eased foreign debt servicing costs and allowed economic growth to be sustained at a higher rate over the 1990s than what would otherwise have been the case. By 2000 the exhaustion of the backlog of public assets that could be sold to foreigners, and the fact that, by market value 45 % of the private non-financial corporate sector was now foreign owned, significantly reduce the opportunities for equity investment."*[16] **This has forced a return to foreign debt acquisition to fund the current account deficit.**

41. Foreign debt is not a problem so long as foreigners are happy to hold Australian debt, which they been in recent years because of Australia's AAA credit rating and relatively high interest rates (5-6% since January 2001, as compared to 2.5-4.5% in the EU, 1-2% in the USA, zero in Japan). However, the interest rate disparity may not last if the US continues to increase its interest rates. An attempt

---

15 Garnaut, R., "The Boom of 1989-And Now", Sir Leslie Melville Lecture 2004, 3 December 2004, p.12

16 National Institute of Economic and Industry Research, "Growth or stagnation: Constructing an alternative scenario for Victorian manufacturing in the new millennium", a report prepared for the MICC, October 2001, p.62

by the Reserve Bank to meet such a rise in Australia, in order to keep foreign banks buying Australian debt, would potentially spark off the housing collapse.[17]

42. In the past this practice has been identified as one of the major reasons for the economic meltdown of developing countries that had previously enjoyed relatively high growth rates. No credible economist or policy maker would support the notion that sustained borrowings should be used to support consumption expenditure. Yet in Australia that is what has been happening for a decade. The cost of this has to be lower long term growth in the future. There are no exceptions to this rule in the experience of other countries, with the possible exception of the United States.

43. Up until now the United States has been able to do it because the US dollar is the international transaction currency. Whether or not the United States can maintain this status is uncertain. The emerging imbalances in the United States economy, however, are beginning to cast doubt on the long run credibility of the US dollar. The shift to the Euro as the international unit of account would curtail United States economic growth on a long term basis.

## Risks For Households And The Economy Of High Household Debt Levels

*44.* High household debt levels pose a significant risk to households and the entire economy. In 1998, Ted Evans, then Secretary of the Treasury, stated that *"…Economic problems, almost wherever they occur, go to the question of debt…in this climate there ought to be a general wariness about debt issues, whether you are a government, an enterprise or an individual."*[18]

45. The risk to the household of high debt levels is fairly obvious. A heavy debt burden with consequently high servicing ratio makes these households incredibly vulnerable to interest rate increases or a reduction in household income.

46. This vulnerability could precipitate the first of 3 risks to the economy from high household debt levels, that is a recession induced by household demand evaporating to service debts. The second risk to the economy comes from the large external imbalance caused by the debt induced current account deficits and spiralling foreign debt levels. The final risk to the economy originates from the misallocation of resources caused by the housing bubble and consumer debt explosion reducing the long term competitiveness of the Australian economy.

### Risks to the Economy

47. The drivers of Australian economic growth over the past decade have been damaging to manufacturing in the short term, and damaging to the growth prospects of the Australian economy in the future. In short, recent Australian economic growth has relied too heavily on the build-up in household debt in

[17] Bramble, T., "Contradictions in Australia's 'miracle economy'", journal of Australian Political Economy, No. 54, December 2004, p.20

[18] Evans, T., Senate Estimates, 15/6/98, p.627

general, and consumer debt in particular. This has produced relatively high growth rates but at a cost. The costs are:

- An unbalanced economy with a declining share of manufacturing in GDP and high current account deficits;
- an unsustainable growth driver which will come to an end once household debt saturation levels are reached; and
- Lower growth outcomes in the future compared to the case that would have resulted if reliance had been placed on alternative, more efficient and sustainable drivers.

### Recession due to downturn in demand

**48.** John Laker, in his first address as the Chairman of the Australian Prudential Regulation Authority (APRA), agreed with the assessment of the Reserve Bank that "…the main potential source of risk to financial stability would be a substantial correction in the housing market, impacting on the balance sheets of authorised deposit taking institutions through mortgage defaults…The concern would be a sharp jump in mortgage defaults which triggered a more substantial market correction – a scenario more likely to be associated with a deterioration in employment conditions or sharp rise in interest rates."[19]

**49.** According to Professor Ross Garnaut the imbalances will eventually attract a strong market response. The immediate mechanism will be a sharp devaluation in the Australian dollar leading to significant increases in the price of imports. This will result in either a fall in consumer demand or a rise in inflation. The latter leading to interest rate rises by the Reserve Bank. Either way the result is a recession[20].

**50.** Some may argue that rising import prices will increase the substitutability of domestic gods and services. This ignores the fact that the capacity to produce goods in these areas has been significantly reduced by the distortion to the economy as a result of the debt explosion, and consequent flood of imports.

**51.** According to Dr. Ian Manning, Deputy Director of the National Institute for Economic and Industry Research:

*"The variable to watch here is household debt servicing costs as a percentage of household disposable income (or income available for discretionary expenditure). A peak of 25 per cent in the late 1980s precipitated the 1990 recession. A major factor in this recession was a slump in consumer demands as households repaid debt. These repayments combined with falling interest rates brought the ratio down to around 19 per cent in 1992, whence it returned to around 25 per cent and stabilised for a few years around 2000, during which period increasing debt was offset by falling nominal interest rates. Now the ratio is again creeping up. As interest rates overseas increase, it is no longer possible to offset the increase in debt by reducing nominal Australian interest rates."*[21]

[19] Laker, J., "The resilience of housing loan portfolios - APRA's "stress test" results", 9/10/03

[20] Uren, D., "Debt Warriors", The Australian, 17 July 2004

[21] Manning, I., "Facing Economic Reality", Dissent Summer 2004/2005 p.50

52. Dr. Manning asserts that as consumer demand declines *"…businesses which serve households will suffer reductions in profit rates and no amount of available credit will induce them to borrow. And remember that trade-exposed businesses have not been borrowing. The multinationals among them have cheaper sources of funds than the Australian banks. The small businesses among them simply have poor business prospects due to their exposure to international competition."*[22]

53. In addition to this, the banking sector will be exposed to several risks:

- A house price down turn leaving some borrowers with negative equity.
- Employment downturn or interest rate increasing leading to greater loan defaults.

54. As well as this, the banks are exposed to foreign exchange risk. A fall in the value of the Australian dollar in relation to the currencies in which they have borrowed could affect their balance sheets (and profitability) severely, subject to whatever hedging they have engaged in to limit this obvious risk. Furthermore, increases in overseas interest rates will rapidly be translated into Australian rates, with an addition to compensate for the fall in the value of the Australian dollar in terms of the lenders currencies.[23]

**External Imbalance risk to the Economy**

55. As discussed earlier, by the late 1980s foreign debt was two thirds of total Australian obligations. However, asset sales to foreigners, partly driven by privatisation of public assets, reduced the debt share of foreign obligations to less than 60%. This reduction eased foreign debt servicing costs and allowed economic growth to be sustained at a higher rate over the 1990s than what would otherwise have been the case. By 2000 the exhaustion of the backlog of public assets that could be sold to foreigners, and the fact that, by market value 45% of the private non-financial corporate sector was now foreign owned, significantly reduce the opportunities for equity investment.[24] This has forced a return to foreign debt acquisition to fund the current account deficit.

56. This resulted in a steady increase in the vulnerability of the Australian economy to a balance of payments crisis. Worsening this situation is the rapid increase in the ratio of short term debt (debt of less than one year to maturity) to Australia's foreign reserve holdings. This ratio has increased from 2 in the late 1980s to over 4 by the end of the 1990s. During the same period the gross short term foreign debt ratio to foreign reserves has increased from 2 to over 7[25].

57. This meant that by 2001, Australia was more vulnerable to a balance of payments crisis than 2 nations that actually experienced a crisis; Argentina and Turkey. The

[22] Ibid., p.51

[23] Ibid., p.50

[24] National Institute of Economic and Industry Research, "Growth or stagnation: Constructing an alternative scenario for Victorian manufacturing in the new millennium", a report prepared for the MICC, October 2001, p.62

[25] Ibid., p.62

table below indicates that in terms of the key balance of payments vulnerability indicators, that is short term debt to reserves and current account balance, both economies are better positioned than Australia. If we include 2004 figures for Australia as well we can see that the Australia's vulnerability is if anything greater than in 2001.

| **Key indicators of a balance of payments crisis - international comparison, 2001**[26] | | | |
|---|---|---|---|
| | **Foreign debt as % of exports** | **Short term debts as % of reserves** | **Current account balance as % of GDP** |
| Indonesia | 186 | 108 | 2.7 |
| Argentina | 423 | 96 | -3.2 |
| Brazil | 332 | 95 | -4.1 |
| Mexico | 93 | 65 | -3.6 |
| Turkey | 197 | 100 | 1.7 |
| **Australia** | **225** | **330 (net)** | **-3.3** |
| **Australia 2004**[27] | **275** | | **-6.0** |

58. Hence, the Australian economy is not only vulnerable to a recession caused by a collapse in consumer demand, but also to a change in international sentiment regarding the Australian economy.

59. Professor Garnaut agrees that there is considerable chance that there will be a major correction to Australia's cost structure relative to the international economy. This correction will either occur through policy choice or the *"…the crude logic of the markets. The avoidance of sudden adjustments through the automatic market processes remains a worthy objective of policy, as it can greatly reduce the costs of adjustment."*[28]

60. Garnaut goes on to reject the argument some offer that the floating currency will ultimately restore the balance of the Australian economy:

*"Whatever the current paradigm, the floating dollar has not repealed the economic constraints on Australian expenditure and development. It has changed the nature of the corrective processes in ways that can assist in avoiding unsustainable imbalances, as well as in correcting them once they have revealed themselves. But the floating dollar removes neither the necessity for nor the pain of adjustment to excessive imbalances once they have been allowed to emerge."*[29]

---

[26] National Institute of Economic and Industry Research, "Growth or stagnation: Constructing an alternative scenario for Victorian manufacturing in the new millennium", a report prepared for the MICC, October 2001, p.64

[27] Balance of Payments and International Investment Position, ABS (5302.0), National Income, Expenditure and Product, ABS (5206.0) and International Trade in Goods and Services, ABS (5368.0)

[28] Garnaut, R., "The Boom of 1989-And Now", Sir Leslie Melville Lecture 2004, 3 December 2004, p.9

[29] Garnaut, R., "The Boom of 1989-And Now", Sir Leslie Melville Lecture 2004, 3 December 2004, p.10

61. Nor are the arguments that the low global interest rates will allow Australia to continually run external deficits justified. The proponents of this view argue that this is the key factor that differentiates the present current account deficit with the one that occurred in the late 1980s. Garnaut believes that this dampener on international pressure will be challenged by the normalisation of global interest rates that commenced in mid-2004.[30]

62. The only reason that the 2004 current account deficits have not attracted as much concern as the ones of the mid 1980s is due to record high terms of trade. **Had the terms of trade stayed at their 1990s average, the external deficit would now be 10 not 6.5% of GDP[31].** Conversely if the current terms of trade existed in 1986 when Paul Keating made the 'Banana Republic' remark, Australia would actually have had a current account surplus. This historic terms of trade cannot last and serve to conceal the true nature of Australia's external imbalance.

63. The central issue surrounding this external imbalance is can Australia land softly? According to Professor Garnaut:

*"That depends partly on events beyond Australians' control. It depends on whether the current high terms of trade continue. For the current high average export prices to be maintained, there would need to be unbroken global economic growth at the China-led rates of 2003 and 2004. There would also need to be some inhibition of international supply response to high prices for our resource exports—some delayed confirmation that the Club of Rome was right in the early 1970s about an emerging scarcity of natural resources…*
*…More probable than the conditions that would sustain current high average export prices indefinitely, would be the continuation of strong, China-led growth in export demand, but with a normal, global resource supply response. In this case, the average real price of our exports could be expected after a while to retreat a long way from their current giddy heights, but remain above the average of the past quarter century. Prices would remain high enough to induce into production a steady stream of new capacity, but without the rents of short-term scarcity that are now an element in price. This is what happened when sustained Japanese industrial growth kept global demand growing steadily in the 1960s. Average future real prices for commodity exports closer to the 1960s than the 1980s and 1990s would be a large and welcome improvement for Australia—but a considerable step down from the prices of the September quarter of 2004…*
*…The Australian outlook will be affected as well by global interest rates. Sustained global growth—and that is what is necessary to hold the terms of trade above the average of recent decades—will take international interest rates that are currently historically low, perhaps back to levels that we once considered normal. Without any lift in Australian rates, this would put immense downward pressure on the Australian dollar whatever the terms of trade. And at current levels of external debt (and those levels are rising quarter by quarter at an awesome pace), and with no Australian dollar depreciation to exaggerate the impact, it would add considerably to the current account deficit as a share of national production."*

---

30 Ibid., p.12

31 Hughes, B., " Beware the terms-of-trade elephant", Australian Financial review, 6/12/04, p.63

*…Australia is unprepared for a setback of this magnitude─shocks of the kind with which every earlier Australian generation has had to contend."*[32]

**64.** An increase in international resource production is already beginning to occur in Australia's chief trading rivals, such as Indian iron ore producers[33]. This will lead to a reduction in our terms of trade and lessen the chances of a soft landing,

**Household debt driven growth has adversely affected the manufacturing sector**

65. The reliance on capital inflow to fund consumer debt has adversely affected the manufacturing sector in a variety of ways. Firstly, it has crowded out direct foreign investment in manufacturing by forcing the interest rates and exchange rates to be higher than what would otherwise have been the case. This is certainly the case currently with Australia's short term interest rates being four times the United States level.

66. Secondly, by allowing unsustainable growth in domestic demand resources, which would have otherwise been allocated for manufacturing expansion, or even the maintenance of installed capacity, have been reallocated to support the expansion in the construction and services sectors. This has resulted in a permanent loss of capacity and exports.

67. Thirdly, governments have begun to think its all too easy. Governments continue to believe that high and sustained economic growth can be achieved by letting the finance sector drive the economy. Governments have cut export assistance and industry assistance programs and have become lazy in efforts to attract direct capital inflow. Governments no longer believe in the importance of manufacturing. They will learn the folly of this position at substantial cost to the Australian economy, Australian workers and their local communities.[34]

68. Garnaut agrees that the weaknesses in export volume growth and in the external accounts is to a considerable extent the result of a decline in Australian competitiveness over recent years. Australian domestic prices have inflated faster than in such important trading partners as Japan, the US, China, Hong Kong, Taiwan and Korea. There has been loss of momentum in productivity-raising reform. These developments have been compounded recently by appreciation of Australia's currency against an average of its trading partners.

69. He goes onto to say that *"…the effects on export growth of declining competitiveness are likely to be compounded in the period ahead by developments in the international trading framework. The comprehensive breakdown of the Asia Pacific trading system into bilateral and small-group preferential trading arrangements that is now in train, and which enters a new stage with the coming into effect of the Australia-US FTA on January 1, is likely to have noticeably*

---

[32] Garnaut, R., "The Boom of 1989-And Now", Sir Leslie Melville Lecture 2004, 3 December 2004, p.18

[33] Hughes, B., " Beware the terms-of-trade elephant", Australian Financial review, 6/12/04, p.63

[34] National Institute of Economic and Industry Research, "The dynamics of growth in Australia's 'lend and spend' economy", August 2003, p.12

*damaging effects on the growth of Australian agricultural and manufactured exports."*[35]

## The Case For Addressing The Lending Policies Of Banks And Other Credit Providers

70. As discussed in paragraph 19. A major cause of Australia's current economic problem has been the failure of the monetary authorities to adopt the rules of monetary policy used by the European Central Bank (ECB).

71. The AMWU is of the view that Australia should adopt the ECB monetary policies goal of using interest rates to control the growth of credit in the economy (represented by m3). The target growth of credit equals the product of the desired growth in GDP and inflation giving a growth of m3 of between 4 and 5 % per annum.

## Possible Changes to Commonwealth Social And Economic Policy Settings

72. Australia must develop growth drivers that are more sustainable than consumer demand financed by foreign debt. The most appropriate driver is the development of competitive exports industries, especially in the area of elaborately transformed manufactures (ETMs).

73. Australia is one of the few countries in the world who deny the strategic role of manufacturing. For most other countries, especially the fastest growing countries of the last 20 years the manufacturing sector is seen as a strategic instrument for generating desired aggregate growth outcomes.

74. A dollar's worth of manufacturing contribution to GDP is, in general, more valuable than the contribution from other industries. This is because, over then longer run, the actual level of GDP growth will be equal to or below the manufacturing output growth. Therefore, Australia to meet a desired level of GDP growth must achieve a manufacturing growth rate at least equal to, and probably greater than, the desired GDP target[36]. This relationship has strong empirical evidence supporting it[37].

75. Why is manufacturing industry a strategic industry that is more important than other industries? Manufacturing is the only industry which can be used to create technology. It is the industry which transforms raw knowledge into wealth creation. A declining manufacturing sector will reduce a nation's technology creation potential leading to declining GDP growth rates.

---

[35] Garnaut, R., "The Boom of 1989-And Now", Sir Leslie Melville Lecture 2004, 3 December 2004, p.18

[36] Note that this will not usually appear as a growth in the nominal share of the manufacturing sector in GDP. This is because productivity growth in the manufacturing sector is greater than for other industries, thus there is a natural tendency for the nominal manufacturing share of GDP to fall.

[37] See "Sabillon, C., "Manufacturing, Technology and Economic Growth", M.E. Sharpe, New York, 2000 and National Institute of Economic and Industry Research "Growth or stagnation: Constructing an alternative scenario for Victorian manufacturing in the new millennium", a report prepared for the MICC, October 2001, p.1.

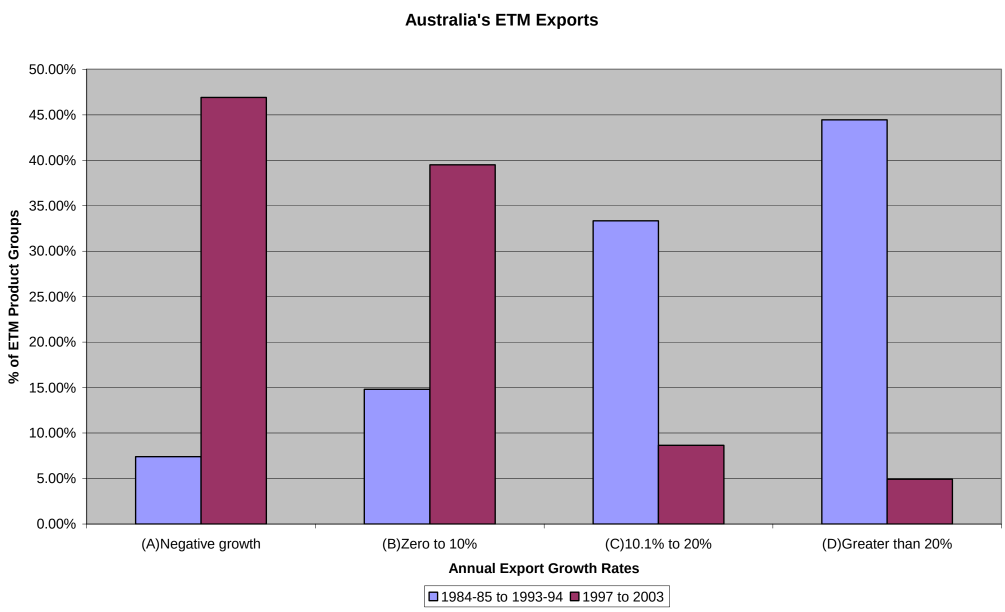
76. Strategic manufacturing industries produce complex and elaborately transformed products which are skill, knowledge and innovation intensive. They are strategic in nature because:

    i) they have strong linkages, both upstream and downstream, with other industries in the economy;
    ii) they are the industries that transfer leading edge technologies to the local economy.
    iii) through the development of skills, organisation and management techniques which spill over to the rest of the economy through labour turnover, supply chain networks, etc…

77. It is essential that the Commonwealth implement active industry policy to promote manufacturing, especially elaborately transformed manufacturing, in particular ETM exporting industries.

78. To do this the Commonwealth must reverse the current trend of a deterioration in the ETM trade deficit. The emphasis on ETM export growth has disappeared under the present government leading to a precipitous decline in annual ETM export growth rates from 17.7% between 1984 and 1994 to 1.8% between 1997 and 2003. The figure below demonstrates the dramatic decline.

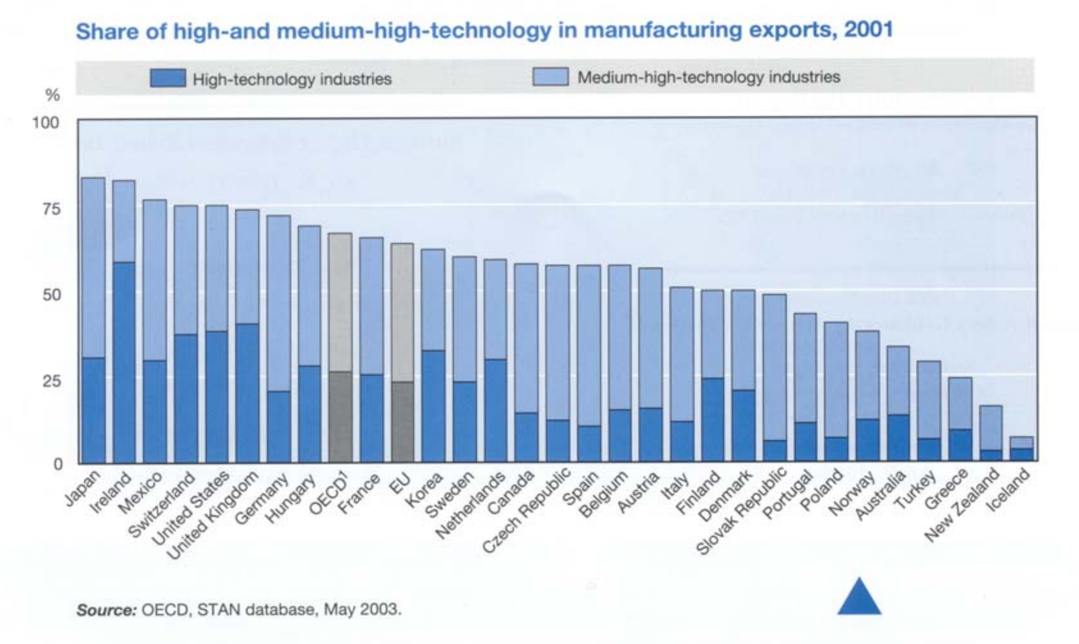
**Australia's ETM Exports by Product Groups**




*Source: National Institute of Economic and Industry Research (NIEIR) Report, derived from DFAT Exports of Primary and Manufactured Products Australia: 1993-94 Edition and 2003 Edition*

79. In terms of exporting high and medium-high technology goods the only OECD economies we perform better than are Turkey, Greece, New Zealand and Iceland.

**Share of high and medium-high technology in manufacturing exports**




*Source: The Knowledge Based Economy: Some Facts and Figures, B-HERT Paper No.7 February 2004*

80. Over the past two financial years, the value of ETM exports actually declined by 10.4% from the 2000-01 level. Over the same period, ETM imports increased by 10.6% to $98.6 billion, resulting in a record ETM trade deficit of $75.4 billion in 2003-04[38].

81. As with the general decline since the mid 1990s, the recent decline in export levels is broad-based, with 13 of the 17 ETM product groups recording a lower level of exports in 2003-04 than in 2000-01.

82. The ETM trade deficit is the equivalent of 10% of national GDP. The growing ETM deficit is making the nation more dependent on minerals and agricultural exports. As a result, there was a record merchandise trade deficit of $22 billion in 2003-2004, up from $14 billion in the previous year[39]. That is Australian consumers are borrowing more and more funds from overseas to purchase imported elaborately transformed products.

83. Australia's mineral and agricultural industries are among the most innovation-intensive and productive in the world. Nevertheless, this sector will only employ directly about 5% of the workforce and is not as important strategically as manufacturing. Therefore urgent action by the Commonwealth is needed.

84. How can we move over from over reliance on growth from household debt financing current consumption to incremental increases in the contribution of innovative, export driven knowledge intensive manufacturing?

---

38 Toner, P., "Lies and Statistics", Australian Financial review, 21/8/2004

39 Ibid.

85. The AMWU believes 7 actions can assist this transformation:

86. **Prudent economic management and solid economic fundamentals.** The Commonwealth must successfully manage the transition from household debt financing current consumption as the main driver of economic growth to more sustainable long term drivers of economic growth.

87. **Accelerate growth of business investment in R&D.** The termination of the 150% R&D tax concession in 1996 was a major factor in manufacturing R&D, going from 10% per annum real growth in the decade to mid 1990s, to negative growth over the 1995-96 to 2001-02 period. The AMWU strongly urges the restoration of the 150% R&D tax concession. Further measures should be enacted to link the availability of R&D incentives to firms upgrading their R&D capability.

88. **Increase greenfield foreign direct investment(FDI).** Between 1985 and 1995 Australia attracted 3.4% of global FDI. However, over the next 6 years Australia's share of global FDI fell to 1.1%. Beyond the actual decline in FDI attraction, the actual situation is worse due to the fact that most of the FDI attracted has been in the resources area. As discussed earlier, investment in the resources area is not as beneficial to the economy as manufacturing FDI. The AMWU puts forward 3 policy options:

    - A fundamental review of Invest Australia to get better outcomes from that organisation.
    - Investment incentives for major projects should focus exclusively on new FDI in knowledge intensive manufacturing activities with the highest incentives for greenfield sites, as well as investment that strengthen supply chains in the manufacturing regions.
    - More emphasis should be given to attracting large global companies to establish R&D/engineering/product development centres in Australia with the accompanying manufacturing prototype capability.

89. **Greater import replacement.** The import share of the domestic market for knowledge intensive manufacturing is very high (around 66%). Two possible policy initiatives are:

    - Increase funding of the Industry Capability Network. Abandon the disastrous cost recovery regime.
    - The AUSFTA Procurement Agreement will still allow Australia to give preference and use offsets for small and medium sized enterprises. A concerted effort should be undertaken to do this. Government should consider legislating the definition of SMEs, on an industry by industry basis, so that it is not challenged under Article 21.2 C of the Agreement.

90. **More new exporters and extend the capacity of existing exporters.** As discussed earlier there has been a dramatic decline in ETM export growth. We need to increase our ETM exports, particularly to East Asia. 3 options to help achieve this are:

- Reformation of the Australian Trade Commission, increasing its focus on exports to East Asia.
- Initiate new forms of engagement with East Asia to assist our ETM trading relationship.
- Greater State-Commonwealth co-operation to double exporters. At the very least, the Commonwealth must remove the cap from the Export Market Development Grant Scheme and increase its funding.

91. **Invest in supporting physical, social, R&D and environmental infrastructure.** It is more than likely that debt funded consumption to not be able to sustain Australia's economic growth much longer. A significant increase in infrastructure funding may fill this void. Almost all rational commentators have rejected the zero public sector debate. Even the Treasurer has indicated that the sale of Telstra will not be used to pay down debt further. All levels of government must increase their funding of physical, social, R&D and environmental infrastructure.

92. **Increase level of private equity investment, especially venture capital.** Growing a new generation of knowledge intensive manufacturing firms, that anchor an increasing share of their export and R&D operations in Australia, will require annual investment levels in venture capital of 0.07% of GDP (European average 1996-2002) to 0.1% of GDP (Canadian and US average 1996-2002) over the business cycle. To meet the 0.07% target over the next seven years will require nearly $5 billion in venture capital investment, or around $700 million per annum. On current trends it would be highly optimistic to see Australia achieve half this, leaving a gap of at least $350 million a year or nearly $2.5 billion over the seven years. To avoid this situation, the AMWU urges the three following actions:

    - The Investment Innovation Fund (IIF) program should seed another group of licensees to help start a new group of venture capital funds that will attract superannuation funds and institutional investors.
    - The government should examine ways of encouraging superannuation funds and their advisors to be more proactive in helping first time venture capital funds to be established.
    - The Commonwealth should continue and improve the R&D Start Grants program, which often helps venture capital managers to invest in technology intensive firms. The State Governments should work with managers and firms to get more businesses venture capital ready.

93. The AMWU submits that if these 7 steps are taken, Australia can successfully move from an over reliance on growth from household debt financing current consumption to an economy driven by growth in innovation and technology intensive exports.

## Conclusion

94. Household debt has reached historic levels. This has driven a massive increase in the importation of consumer goods, leading to an explosion in Australia's foreign debt and resulting a series of record and unsustainable current account deficits.

95. The growth in household debt has been the driver of Australia's economic growth over the last 8 years, particularily the last 2 years. The AMWU submits that this is clearly unsustainable. The level of debt, and consequent high debt servicing ratios, makes Australian households incredibly vulnerable to extreme hardship should the economy decline or interest rates increase (which seems more and more likely).

96. The risks to the general economy of these high levels of household debt are threefold:

    - An unbalanced economy with a declining share of manufacturing in GDP and high current account deficits;
    - an unsustainable growth driver which will come to an end once household debt saturation levels are reached; and
    - Lower growth outcomes in the future compared to the case that would have resulted if reliance had been placed on alternative, more efficient and sustainable drivers.

97. The AMWU's submission concludes by proposing policy solutions to the current debt crisis. This involves addressing Australia's persistent external imbalance and developing sustainable drivers of economic growth. The seven policy solutions are:

    - Prudent economic management and solid economic fundamentals
    - Accelerate growth of business investment in R&D.
    - Increase greenfield foreign direct investment(FDI).
    - Greater import replacement.
    - More new exporters and extend the capacity of existing exporters
    - Invest in supporting physical, social, R&D and environmental infrastructure
    - Increase level of private equity investment, especially venture capital.

98. The AMWU would like to thank the Senate Economics References Committee for the opportunity to make this submission. The AMWU would value any further opportunities for consultation with respect to this inquiry.