

**Senate Economics Committee Inquiry
Notes on the Australian Business Investment Partnership.
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We don't have a 'financial crisis' in Australia - at least not yet. And there is no need for one. But there is a risk. Do we want to take that risk?

We don't have a 'financial crisis' in Australia - at least not yet. The banks don't have to write off significant bad debts associated with non-performing loans, eroding their equity base. In Australia, this is nothing like the 1989 experience caused by the investment boom of the 1980s and resulting in the recession of the early 1990s. There is not a significant oversupply of property. Indeed, following the action of the Reserve Bank to nip the housing price bubble in the bud in 2003, the residential markets are underbuilding and significantly undersupplied.

That contrasts with many developed overseas economies which are experiencing a 1989-style phenomenon, only more severe. Hence the bad debts, erosion of bank equity and the need to refinance the banking sector. Hence also the prospect of severe recession and protracted weakness in their economies.

There are, however linkages to the global financial crisis. Australia is experiencing a credit squeeze and an equity squeeze.

- **Australia has an overseas borrowing requirement associated with the financing of the Current Account deficit and the need to roll over maturing overseas debt. With the Federal Government guarantee, the banks can borrow from overseas markets but it remains expensive.**
- **Troubled overseas corporations and financial institutions have been cashing in their overseas investments, including those in Australia, affecting both share prices and the exchange rate.**

Last year, the global financial crisis changed attitudes to risk in both debt and equity markets.

The (undersupplied) residential market has been relatively unaffected. Favoured by Basel II, there is plenty of finance available for the mortgage belt and for residential property investors at good interest rates. However, business lending, and particularly property loans, have been hit by a severe credit squeeze, paying substantial margins above market rates ... if they can get a loan.

For the LPTs, who own most of the institutional grade commercial property in Australia, the last year has seen a rolling collapse of share prices and pressure to reduce gearing. This, after a long period where institutional investors had been aggressively and successfully pressuring LPTs to gear up to maximise dividends and hence, they thought, total returns. Now, greed has switched to fear. The banks

think they're overexposed to property and are trying to reduce gearing. The sector needs an equity injection to reduce gearing. But the super funds are fleeing to the security of fixed interest, and they're the only equity investors large enough to make a dent. Both are trying to reduce their exposure.

The LPTs are under pressure to sell assets, with little prospect of success. Markets aren't clearing. Prices have already fallen and will fall further before this is over. LVRs are rising, not falling. Finance for development has evaporated.

Meanwhile, the economy is weakening with a major downturn in prospect this year and next causing a shock to the demand for commercial property. Vacancy rates will rise and leasing markets weaken, with the associated fall in rents leading to further falls in prices.

Commercial property markets will feel the combined impact of the credit/equity squeeze plus the shock to demand. But there is not major oversupply. Had the cycle run its course, there would have been. We would still be building now. But the saving grace from the credit squeeze is that the next round of projects has been curtailed so that, once the current round has completed, net additions to space will fall to virtually zero. That means that, once demand picks up again, excess space will be quickly absorbed.

Sydney and Melbourne will be building again within five years. The minerals boom, now bust, states will take longer. And, given that neither debt nor equity investors are likely to underwrite speculative projects, rents and property prices will need to be back at replacement cost levels before we build.

Though severe, this downturn has, in the scheme of things, a short horizon. Provided that debt markets don't force sales, there need not be any substantial debt write-offs. Certainly, falls in prices will increase, not decrease, LVRs. But, the banks are locked in. Apart from over-g geared financial engineers, most LPTs should remain in positive equity territory. They can ride it out.

In the short term, the risk is that banks will break ranks. They think they're overexposed to property and would be reluctant to provide significant additional funding. With insufficient buyers, forced sales would lead to a collapse in prices. And the danger it is that it will be the attempted exodus by overseas banks that precipitates a crisis. If severe enough, it could turn into a financial crisis for the banking system, causing a much more severe economic downturn.

We see the role of ABIP as preventing this outcome.

What's the alternative?

Comments:

- **We see the primary objective of the ABIP as preventing a financial crisis not stimulating development.**
- **Lending should be on prudent commercial terms, focusing on refinancing debt funding to replace departing overseas banks.**
- **Currently, most development projects cannot proceed, not only for lack of funding, but also for lack of financial feasibility and lack of take-out of the end product. The first cab off the development rank will be residential. Commercial projects will take longer to achieve financial feasibility.**
- **This is debt not equity finance. It doesn't solve the problem of replacing debt with equity. It just prevents an unnecessary collapse.**