What Credit Ratings don't Tell Us

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Bill Shorten might be using the downgrading of European economies as an opportunity to crow about Australia's prosperity - but being rich and having a sound economy are not the same thing, writes Ian McAuley.

When Standard and Poor's cut France's AAA sovereign credit rating and downgraded the ratings of eight other European countries, Bill Shorten couldn't resist an undignified outbreak of Schadenfreude:

"S&P's decision overnight to strip France of the exclusive, top-tier AAA credit rating confirms once again the stark contrast between Australia's rock solid economic fundamentals and the fiscal challenges facing Europe and other parts of the world" he said in a statement last Saturday.

Shorten must be one of the few people who still take these ratings seriously. After all, S&P was one of three agencies that was still giving Lehman Brothers a strong rating just days before it declared bankruptcy in September 2008. As if to confirm the irrelevance of ratings agencies, France's cost of borrowing has actually fallen in the days since its downgrade.

His main error, however, is to confuse a credit rating with an assessment of Australia's "economic fundamentals".

A credit rating, even if accurate, is simply an assessment of a government's capacity to repay its debt; it says little about a country's underlying economic strength. It would be amazing if Australia, with its huge mineral reserves and low government debt, did not have a high credit rating.

It happens that countries with strong economies, such as the northern European countries, are also those with AAA credit ratings. But most oil-exporting countries, many of which have very weak economic structures, also have reasonably strong credit ratings. Being rich and having a sound economy are not the same thing.

Europe's main problems are an immediate fiscal crisis which could drag the region into a prolonged recession, but most European countries have far more economic depth than Australia.

France is a world leader in high value-added industry, in aerospace, pharmaceuticals, telecommunications, defence equipment and civil engineering. It may have high government debt — about 80 per cent of GDP — but much of that debt has gone to fund productive infrastructure, such as its high speed rail network and urban metro systems. By contrast we struggle to keep our car industry alive and have a third world rail network. We may have low public debt, but on the other side of the national balance sheet we don't have much in the way of public assets.

When the mineral boom eventually ends, Europe's troubles of 2012 will be no more than a memory. Most European countries will still have reasonably strong and diversified economies. By contrast, unless we modernise our economy, we could slip into a condition far worse than a recession. Nauru provides an extreme example of what happens once a commodity-based economy loses its export base.

Australia's economic weaknesses are not of this government's making. It was the Howard government which squandered the benefits of earlier economic reforms and allowed our public revenues to be diverted from national investment in education, infrastructure and environmental protection, and re-directed to middle-class welfare and tax breaks for the well-off. They left us without debt on the fiscal balance sheet, but they left us with a huge liability to replace and repair our worn and crumbling infrastructure. Those are liabilities which staff of the ratings agencies don't see.

So far, however, both the Rudd government and the Gillard Government have continued with the Howard-Costello policy, with a little tinkering at the margins, most notably in relation to labour relations. It is yet to tackle the hard task of re-building our economic strength to ensure that our prosperity can endure once the mineral boom has ended.