The Real Hole In Labor's Economic Policy

14 January 2013

As the argument over Labor's economic management and missed surplus rages on, the Government is about to repeat a key mistake of the Howard years - letting private debt grow, writes Ian McAuley.

When the Treasurer, just before Christmas, announced that a budget surplus this financial year was unlikely, The Australian's response was to announce that "Labor's budget strategy is in disarray."

The chaos seems to have missed the attention of the International Monetary Fund (IMF), who have once again commented favourably on Australia's "prudent economic management". And it missed the attention of the ratings agencies, who failed to downgrade Australia's AAA rating. Perhaps officials in the IMF and Moody's just don't read quality newspapers like The Australian and the Pyongyang Times.

In fact there has been no substantial change in Australia's budgetary situation. Swan was responding to a $3.9 billion revenue shortfall over the first four months of the financial year — a period when commodity prices took a temporary dive. That moves the budget outcome from a cash surplus of $1.1 billion as expected in the November updates to a deficit of $2.8 billion. In a $370 billion budget that's less than 1 per cent.

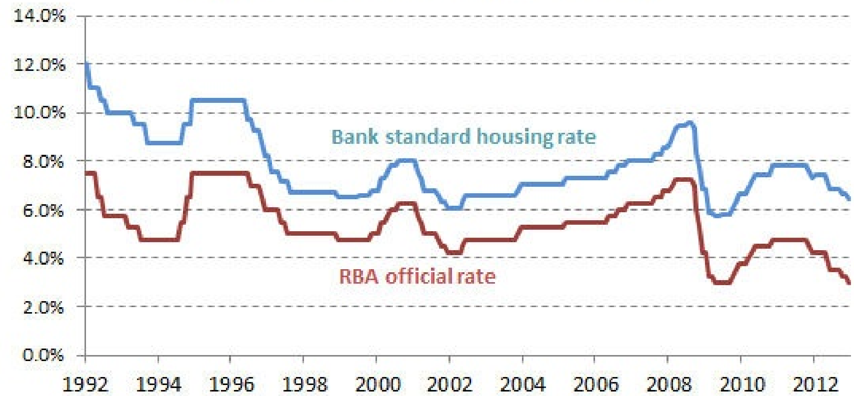
It was unwise for the Government to crow about a planned surplus, but its announcements were about impression management. It was spooked by the puerile representation of the budgetary situation by Tony Abbott and Murdoch journalists, who would have us believe our public finances are in Mediterranean-style freefall. Also, announcement of a tight budgetary situation is a time-honoured strategy of treasurers to suppress the demands of ministers with their long shopping lists.

Nitpicking attacks on budgetary estimates have distracted attention from the broader question of whether the government should be committed to a tight fiscal policy in these uncertain times. Employment growth is slowing; indeed unemployment would be rising but for a fall in the labour force participation rate. Recent global events are promising, with the Americans avoiding the "fiscal cliff" and the Chinese economy picking up, but so far this financial year the Australian dollar has appreciated by 4 per cent against the US dollar and by 3 per cent against the trade-weighted index, putting further stress on trade-exposed industries.

If fiscal policy is committed to a balanced budget, the task of economic stabilisation is left to monetary policy. That's the job of the Reserve Bank, with its one big lever — the official cash rate.

In fact it has been the Government's fiscal policy for some time to leave the work to the RBA. While fiscal conditions have been tightening, the Reserve Bank has been reducing interest rates in order to prevent the economy from contracting. There have been reductions in seven of the last thirteen months. Official rates have fallen from 4.75 per cent in late 2011 to 3 per cent in December 2012. Housing rates have similarly come down, but not by so much.

Figure 1 Nominal interest rates



Those who foresee hard times this year expect rates to fall even further. NAB economists, for example, are tipping a fall to 2.25 per cent before the year is out.

No doubt those paying off a mortgage will enjoy this outbreak of monetary easing. Although banks have become more stingy about passing on interest rate cuts, nominal housing rates are now as low as at any time over the last twenty years.

Retailers too will welcome the rate cut, although it is doubtful whether their problems will be solved by putting a little more money into consumers' hands.

But is it wise to leave so much to monetary policy? Monetary policy is a powerful but slow acting policy lever. Anyone who has ever taken the wheel of a large boat or the control yoke of a powerful airplane will know about the problems of overcorrecting, and monetary policy carries similar risks, particularly as far as housing is concerned.

Australians are only now recovering from a bout of house price inflation and an associated growth in household debt during the years of the Howard Government. Between 1996 and 2007 the average level of household debt doubled, from 80 per cent to 160 per cent of annual income, from where it has been falling very slowly over the last few years.

This is the debt that dares not reveal its name — private debt. We are supposed to believe that only public debt matters — and that the Howard government got us out of debt in the first place.

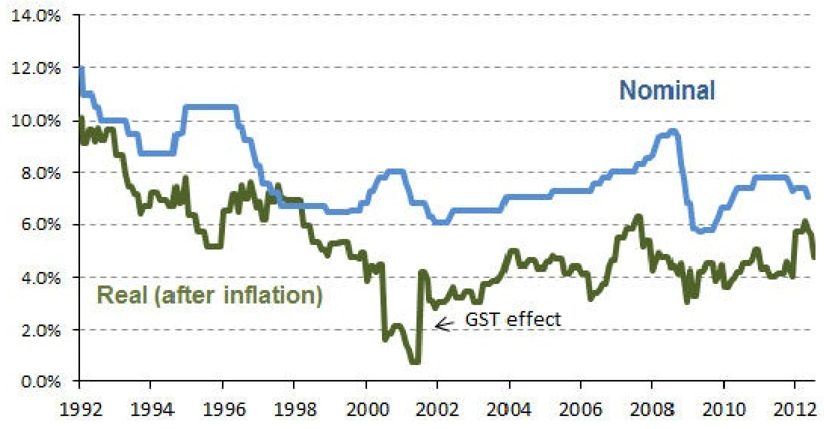
The main driver of debt was housing price inflation, and as people's nominal house values rose so too did their feeling of wealth. Mortgage redraw facilities gave borrowers an opportunity to translate the illusion of increased prosperity to the reality of higher debt.

When it comes to new home buyers, borrowers' decisions are influenced by the allure of low nominal borrowing rates, even when real (after inflation) rates are quite high.

But even Treasurer Peter Costello, when he talked about low interest rates, showed he didn't understand the difference between nominal and real rates. Nominal rates are the ones we see advertised, but real rates are what influence the burden of repayment. In simple terms, the real rate is the nominal rate minus inflation.

As shown in the second graph, which repeats the nominal housing rate from the first graph but adds in the real (after inflation) rate, real rates are not particularly low. (The dip in 2001 is a statistical artefact resulting from the changes associated with the introduction of the GST.)

Figure 2 Bank standard housing rates



Low interest rates, particularly when they occur at the same time as low inflation, encourage borrowing. After all, that's their intention, but the economic orthodoxy is that such borrowing should be for productive investment. That orthodoxy was developed in a period of moderate inflation, and before banks were so willing to extend credit through instruments such as mortgage redraw.

A likely consequence of low interest rates is a resumption of housing price inflation — blowing up the bubble — and a reversal of the slow process of paying down housing debt. By any reasonable policy criterion (unless one believes it is desirable to stimulate the finance sector) these are undesirable outcomes. We still have high household debt and, by world standards, overpriced housing.

If the government is to be criticised, it is not for narrowly missing the bullseye of a fiscal target. Rather, it is for setting that target in the first place, and for not explaining the fundamentals of macroeconomic management to the electorate to give itself the room to continue with a minor fiscal stimulus. It is in danger of repeating the mistake of the Howard government which, in its obsession with public debt, allowed private debt to grow unchecked.